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TAXATION OF LUXURY GOODS

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ABSTRACT

Countries are engaged in a tax competition that leads to a reduction of the budget revenue. The aim of this research is to evaluate taxation of the luxury goods, to evaluate their potential distributional effect and types of goods to be taxed. Results demonstrate that tax on luxury goods could be used to compensate the reduction of tax revenues. The tax on luxury goods would reduce the regressive tax burden of consumption taxes. However, there is a need for more studies of what goods could be considered a luxury as well as how to organize tax administration in open markets.

Keywords: *consumption tax, luxury goods, tax on luxury goods, the tax burden*

1. INTRODUCTION

Due to globalization, countries have been engaged in a tax competition that leads to a reduction of the tax burden in order to attract investors and make taxpayers more competitive. As a result, state budget revenues are falling. It needs to be compensated by an increase of other taxes. The most popular taxes are taxes on consumption, such as excise taxes or environmental taxes. However, such opportunities are limited by the purchasing power of consumers and the expansion of the illicit market. Environmental taxes cannot significantly contribute to the state revenues and in many cases have an adverse effect on low-income earners (Juruss & Brizga, 2017). In 2014, taxes on labour in OECD countries constituted the largest tax revenue share with total amount 59.9% (taxes on income and profit accounted for 33.7% and social security contributions accounted for 26.2%). The revenue share coming from taxes on goods and services was 32.6% (consumption taxes amounted to 30.5%). This proportion has not significantly changed for the last 35 years, there were only some changes on components of the tax burden on labour - tax burden on income and profit from 1980 to 2009 decreased and simultaneously tax burden on social security contributions increased (OECD, 2016). In addition, one of the challenges facing the world is income inequality. For example, average GINI coefficient of income inequality in OECD countries in the mid-1980s was 0.29 but by 2013 it had increased in 17 of 22 OECD countries by 10% to 0.32 (OECD, 2015).

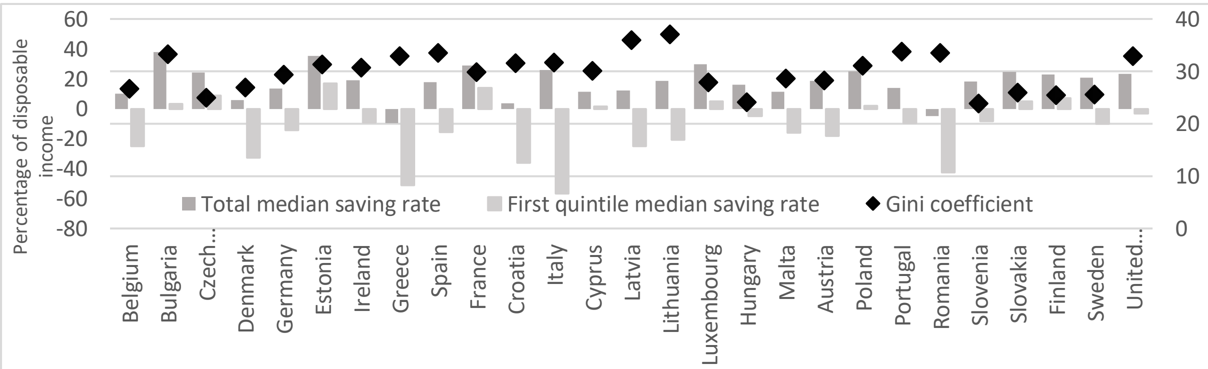
We can also see that the average income of the top income earners is growing faster than any other income bracket (Euromonitor, 2017), creating greater demand for luxury goods and overconsumption. This is also linked to environmental sustainability as the top 10% of world population, are responsible for about 34% of household-related direct and indirect greenhouse gas emissions (Hubacek et al., 2017). These figures show that the highest tax burden is on labour taxes and income inequality across the countries remains very high, but the unsustainable consumption patterns of the high-income earners have a significant contribution to the environmental degradation. We can see that current tax instruments are not effective both fiscally and social-economically. One of the ways to increase tax revenues, reduce income inequality and environmental impact and simultaneously deflect tax burden from labour taxes to consumption taxes is to introduce the luxury tax - additional tax on luxury goods that might raise revenues and would not leave harmful tax burden on low incomes earners. The aim of this paper is to evaluate taxation of the luxury goods with an additional consumption tax. The tasks of the research are to study the research literature on this topic, to evaluate the potential distributional effect of such taxes and to evaluate the potential types of goods to be taxed. To do this we have been using quantitative data analyses to analyse consumption of luxury goods, taxation and other data for the three Baltic States and Poland, as well as qualitative desk research to study existing literature on this topic.

2. LITERATURE REVIEW

2.1. Income inequality and luxury goods

Year by year one of the main social and economic problems is inequality of income, the gap between the rich and the poor in the world gets bigger because the rich people become richer but the poor become poorer. In 2010, the average Gini coefficient in the EU was 30.5 and in 13 out of 28 EU member states Gini coefficient was above the EU average (Fig.1.). Analysing median saving rate by income quintile mostly these countries had a problem with savings when people of the first quintile could not use disposable income for savings.

Figure 1: The Gini coefficient and median saving rate in EU countries in 2010



Source: EUROSTAT, 2018

In some countries, this problem reaches up to the third income quintile (including) but in Greece even to the fourth quintile (in this quintile savings form -0.4% of disposable income). It indicates that people spend all or the biggest part of their income on everyday consumption. For example, in 2010 the aggregate propensity to consume in the first quintile forms 168.1% of disposable income in Latvia; the same situation can be also observed in Lithuania where the aggregate propensity to consume was 164.2% of disposable income). In contrast, in Latvia in the fifth quintile the above-mentioned indicator forms only 68.2 and in Lithuania only 53.1% of disposable income. This demonstrated that high-income earners could spend a significant part of their income on inessential luxury goods.

Inequality and luxury goods have existed for centuries (Som & Blanckaert, 2015); however, there is no one clear definition of luxury. One of the most commonly used definitions is that luxury goods are goods for which the usage or display of a particular branded product provides status or prestige to its owner along with any functional utility (Grossman & Sharpiro, 1988). Status symbols the goods are providing, of course, are important not only for the high-income earners; however, they have more means to satisfy these needs. In different cultures, consumption patterns can be different, which are influenced by various factors, for example, in Arab culture individual's exhibit an affiliation-oriented nature whereby collective interests and family and group values are set as a priority compared to one's private life. In any case, in Arab culture, strong religion and culture boundaries exist and consumers do not purchase luxury products due to poor lifestyle, social status and low salary. However, Arab consumers are willing to buy conspicuous products that demonstrate social rank (Farah & Fawaz, 2016). In the luxury goods industry, different risk factors should be considered, like smuggling and counterfeiting. Luxury brands are one of the main targets for counterfeiting. It is an expanding and increasingly important issue in contemporary markets that have an impact on luxury branded goods. Counterfeiting is a really huge issue to luxury brands' products because then they become more common and luxury brands lose its status, quality and uniqueness compared of other brands (Gistri et al., 2009). The quality, materials and high price are the major factors that make luxury brands so luxury. Most people use luxury brands because it delivers the highest sentimental and ideational value and fulfils their needs of self-esteem. In addition, luxury brands serve to provide respect and recognition from others and demonstrate person's achievements in life (Scholz, 2014). It will be optimal to find out those goods that are consumed primarily to display the owner's wealth and these defined goods charge the luxury tax (Griffith, 2003). Nowadays, luxury goods refer both to luxury for personal use and are the aggregation of designer apparel and footwear (ready-to-wear), luxury bags and accessories (including eyewear), luxury jewelry and watches, and premium cosmetics and fragrances, as well as typical luxury goods as expensive cars, travel and leisure services, boating and yachts, fine art and collectables, and fine wines and spirits. Global luxury goods sales have been growing by 4% in constant terms reached USD 954 billion in 2017 (Euromonitor, 2018). The fastest growing luxury goods markets are in the Asia Pacific, the Middle East and Africa. Top five luxury goods markets are USA, China, Japan, Germany and United Kingdom. In Germany market size of luxury goods grows rapidly because German consumers' the perception of luxury consumption has improved and they have started to increase their spending on personal luxury goods. (Shane, 2017). Luxury cars remain the cornerstone of the industry with sales accounting for almost 53% of all global luxury goods sales in 2017, followed by designer clothing and footwear (13%), fine wines/champagne and spirits (7%), luxury jewellery and watches (7%) (Euromonitor, 2018). The healthy and sustainable living is also becoming the new wealth symbol. It is becoming increasingly important also for luxury brands to increase their social-ecological stances. The world's 100 largest luxury goods companies generated sales of USD 212 billion in the financial year 2015. The total average luxury goods annual sales for a top 100 companies in 2015 was USD 2.1 billion. In 2015, the biggest average size of companies by luxury goods sales (in the amount of USD 6.3 billion) was luxury goods companies that sell multiple luxury goods (companies with substantial sales in more than one product sector). The least average size of companies by luxury goods sales was apparel and footwear companies (USD 1 billion) (Deloitte, 2017). In 2015, LVMH Moët Hennessy Louis Vuitton S.E. took the first place in the sales ranking of Top 100 luxury goods companies and this company's luxury goods sale grew by 15.2%. Compagnie Financière Richemont SA and The Estée Lauder Companies Inc ranked second and third and their sales grew by 6.4 and 4.5% accordingly (Deloitte, 2017) (Table 1).

Table 1: Profile of top 5 luxury product sectors in 2015

No	Question	Number of companies	Luxury goods sales growth compared to the previous fiscal year, %
1.	Apparel and footwear	41	4.4
2.	Bags and accessories	10	13.4
3.	Cosmetics and fragrances	10	6.5
4.	Jewellery and watches	28	2.0
5.	Multiple luxury goods	11	10.8

Source: Deloitte, 2017

2.2. Classification of luxury goods taxes

Taxing luxury goods is not a new idea. One of the biggest booms in taxing luxuries was after the First World War. At that time the main purpose of these taxes was to raise additional resources for destroyed economies. However, the purpose of the luxury tax is not only fiscal but also to repress undesirable and extravagant expenditure and improve income equality. Nevertheless, luxury taxes could take different forms, e.g. of differentiated income tax, property taxes or consumption-based taxes, e.g. differentiated value-added tax or tax on specific products (chocolate, luxury brands, jewelry and watches etc.) (See Table 2.).

Table 2: Principles of luxury taxation

Base	Over-income	Wealth	Extra-consumption
Type of tax	Income tax	Property taxes	Value-added tax Excise duty Import duty Other consumption taxes
Examples	Progressive personal income tax (wage, dividend, interest) Taxes on gambling	The progressive real estate tax Progressive vehicles taxes (luxury cars, yachts etc.) Capital tax	Differentiated value-added tax Tax on specific products (chocolate, luxury brands, jewellery, watches, etc.)

Source: by the authors

The idea behind the luxury tax is that the most remote from necessity must be the most heavily taxed (Orain, 2010). It could be luxury cars (Beijing Review, 2013) which account for the most of the luxury expenditures. In European countries it is common to use taxes if they're connected with good and luxury life, for example, paintings, musical instruments, furniture, etc., what people actually do not need as the main necessity. In France photographs, jewellery, antiques, sporting games, mechanical pianos, motor cars, billiard tables, perfumes, sculptures, yachts, silk underwear, liqueurs, watches, etc. were believed to be obvious luxuries. General articles such as clothing became a luxury when the price exceeded a certain sum. Other countries had also included a miscellaneous assortment of additional excise taxes (Bogart, 1919). It could be also as a tax on aggregate professional sports player salary expenditures above a specified level (Kaplan, 2004). It is rational to collect taxes according to different consumption models because the consumption tax on luxury goods is aimed at consumption at a higher level than usual and it does not affect consumption of everyday products. However, tax on luxury goods consumption is an ineffective solution to narrow down the gap between the rich and the poor both in the short and the long term. Tax on luxury goods can have an effect on people with middle income if they buy luxury products thus such a tax can affect relatively poor (Beijing Review, 2010). Therefore, target groups of the luxury tax can differ and some of the affordable luxuries, e.g. chocolate is already taxed in many countries with excise duty.

3. METHODS

The reason for the introduction of luxury tax should be not only to raise additional state revenues but also to ensure social economic and environmental impact. As there is still very high inequality in many countries (OECD, 2015), luxury taxes would be as one of the tools for redistribution. There are two directions of taxation of luxury: taxing income or expenditure. As rich persons buy luxury goods more, it would be logical to tax income of rich persons more or apply progressive income tax. Another option is to tax expenses of rich behaviour or in other words apply a luxury tax on consumption of rich progressively. There are indirect taxes – value-added tax, excises or others, which are paid by taxpayers (traders, producers) and therefore tax burden is actually passed to persons purchasing the specific goods. Real estate or other property like exclusive luxury cars, yachts or any other such property could be taxed as well. To understand the impact of taxes a method of assessment of consumption tax burden, which was developed by Jurušs and discussed in his doctoral theses, can be used (Jurušs, 1999). The method is based on the theory of consumption by John Maynard Keynes, particularly to a concept of the marginal propensity to consume (MPC). The method is described in more detail in a publication about tax policy impact on income inequality in Latvia (Jurušs, 2016). This method allows to describe the nature of changes of tax burden depending on the level of income, however, in practice, there might be limitations, exceptions and anomalies affecting consumption and income. For example, there may be cases where an individual's behaviour is different for various reasons, and thus a particular case may also have a different result. The results may be affected also by other factors such as illegal economic trends (Jurušs, 1999). This method can be applied in practice to compare tax burden of various income level (or quintile groups) by observation of disposable income and consumption. Particularly, consumption tax burden on a specific level of income can be calculated by the following formula:

$$Tcn = Tca\ (Cn / Ca) / (In / Ia) \tag{1}$$

where:
Tcn – consumption tax burden on a specific level of income,
Tca – average consumption tax burden,
Cn – consumption of specific level of income,
Ca – average consumption,
In – income of specific level of income,
Ia – average income.

In the case study to create a methodology for luxury tax estimation model, consumption tax burden estimation was used. Data from the Central Statistical Bureau about income and expenditures of one person in a household by quintile was used for this model (CSP, 2017) and consumption tax revenue in Latvia (Eurostat, 2017). The methodology consists of three steps:

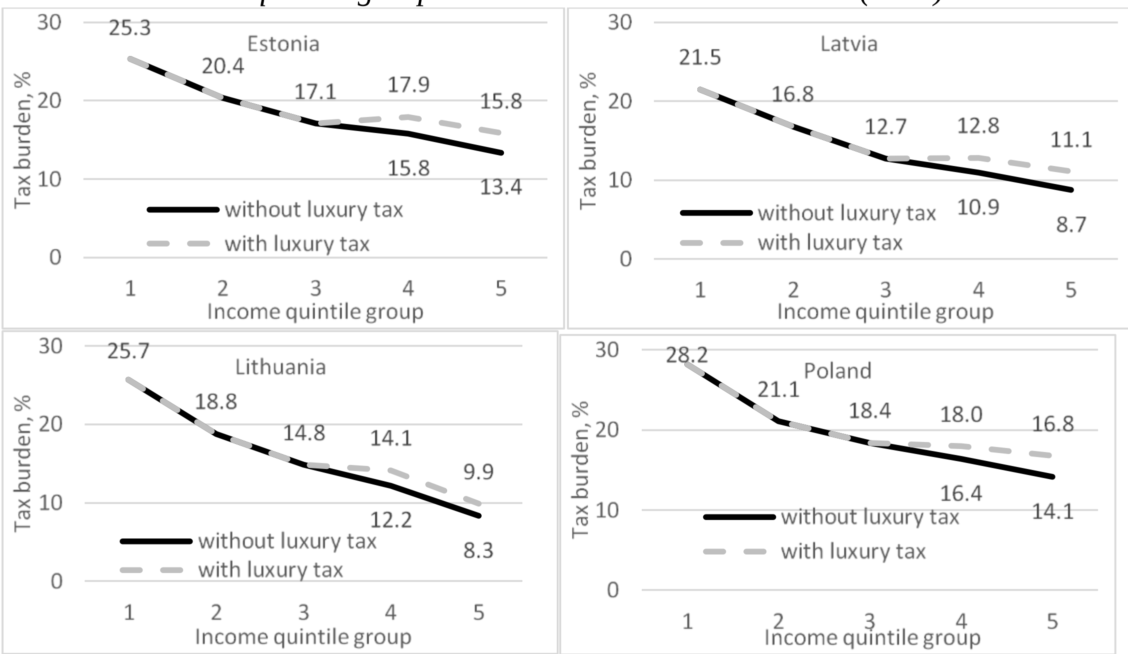
- The first step is to find out the current tax burden (before) of consumption tax according to the data on consumption tax revenue by quintile and by income and expenditure;
- Second step – to determinate luxury expenditure and then find out the tax burden (after) of luxury tax;
- Finally – estimate the impact on the tax burden of luxury tax by quintile before and after luxury expenditure determination.

4. RESULTS

In this case study, the tax burden on consumption by income quintile groups with and without luxury tax in the Baltic States (Estonia, Latvia, and Lithuania) and Poland is analysed.

The luxury expenditure was determined by determination of the difference between the expenditure of fourth and fifth quintile. Then the luxury tax at the rate of 10% was applied (as an additional tax to general consumption taxes). Fig. 2 shows changes in the tax burden of consumption taxes before and after determination of luxury expenditure. In this case study applying the luxury tax of 10%:

Figure 2: The tax burden on consumption without luxury tax and with luxury tax by income quintile groups in the Baltic States and Poland (2010)



Source: author's calculations (based on data from EUROSTAT, 2010)

- In Estonia, the consumption tax burden in the fourth quintile increased by 2.2% and in the fifth quintile by 2.5%. Tax revenue on production and imports increased by 9%;
- In Latvia, the consumption tax burden in the fourth quintile increased by 1.9% and in the fifth quintile by 2.3%. In this case study, the biggest tax revenue from production and imports increase was in Latvia (12%);
- In Lithuania, the consumption tax burden increased by 2% (in the fourth quintile) and by 1.6% (in the fifth quintile). Revenue from taxes on production and imports increased by 9%;
- In Poland, the consumption tax burden increased by 1.6% (in the fourth quintile) and by 2.7% (in the fifth quintile) and revenue from taxes on production and imports increased by 8%.

5. DISCUSION

Economic growth involves two aspects of sustainability. One of them is the need to use increasing quantities of resources to produce higher growth. The second aspect - during growth there is an additional problem of maintaining a balance between the consumption of the rich and the poor. If the economy grows rapidly, some groups of the population have more than proportionate rise in income and this leads to an increased production of luxury goods. Since the production of luxury goods often requires more resources, it may reduce not only the production of necessary goods but also total production. When an economy experiences initial growth, the high-income earners utilize the growth opportunity better than the low-income earners, leading to increased income inequality.

This inequality increases the demand for luxury goods. The resultant change in the resource allocation may threaten the sustainability of the consumption level of the poor (Datta, 2014). Luxury tax could help diminishing these misbalances, but it is necessary to continue the discussion and study whether and for which goods a luxury tax should be introduced. The tax and terms of the tax may vary between developed and developing countries. The main purpose of the luxury tax is not the fiscal, but rather distributional aspects and drive for more sustainable consumption patterns by taxing non-essential goods. However, the risk of growing illegal markets should be taken into account, as additional taxes will increase prices and people will want to buy it illegally or in other markets. In this respect, international cooperation and access would be required, for example, at the European Union level. A practical solution could be to increase VAT on specific goods. Most countries use both income taxes and expense taxes, e.g. VAT and excise taxes. Therefore, there are options to choose one or the other way to apply a differentiated higher tax to particular goods affecting some of the social groups. The luxury tax is one of these options. It is possible to avoid both income and expense taxes, and therefore tax evasion argument is not so important when considering one or the other approach. In addition, income taxes related to labour supply, which means they have a more significant impact on economic growth. A luxury tax on consumption could be politically easier to approve. Moreover, luxury goods are not essential commodities and their demand is inflexible, so price changes would have less effect on their consumption, thus ensuring more revenue to the state budgets. Literature analysis and our case study shows that the additional tax on luxury goods could be one of the alternatives to compensate the reduction of income tax revenues due to tax competition in the global market. The additional tax burden on luxury goods would reduce the regressive tax burden caused by consumption taxes because such luxury taxes would affect the rich persons. However, there is no clear unified understanding, which products, services, and lifestyles could be considered as a luxury (Wiedmann et al., 2009). A direct implication is that luxury taxes are inefficient tools for achieving distributive objectives (Kaplow, 2011). The expenditures by households are different because poor households' expenditure is based on their needs but richer households can afford more luxury goods. If most consumption taxes were levied on luxury goods, it would be necessary to conclude that they are fundamentally redistributive (Beramendi & Rueda, 2007). Another remedy, if only applied in time, is the imposition of excise taxes instead of tariffs on luxury goods. The luxury tax for goods that are not produced at home functions just like a tariff that is collected on imported goods. However, the luxury tax has equal impact on foreign and home production; inefficient domestic production is not stimulated but at the same time, there are no barriers to efficient domestic production that could compete with the world market (Harberger, 1990). Income inequality is caused by unemployment, emigration and demographic change. However, a significant impact on income inequality is created by an unfair tax policy and an inefficient system of revenue redistributions, social transfers and benefits that are unable to offset the adverse effects of the unfair tax policy. Persons with lower incomes spend proportionally a much bigger part of their income on consumption than persons with higher income, which means that persons with low income have the heaviest consumption tax burden (Jurušs, 2016). Therefore, changes in taxation principles are vitally important to create fair tax policy and minimise income inequality.

6. CONCLUSION

Commodity taxes must be combined with the application of other taxes and depend on, for example, the existence of a proportional or linear income tax or a progressive or non-linear income tax, including taxation of luxury goods. If governments use proportional or linear taxation, taxation of commodity goods at lower rates than luxury goods, have a positive effect on equity but have unclear efficiency effect.

However, in case of optimal non-linear income taxation, commodity taxes should be uniform, even if there are people with limited income (Boadway & Song, 2016). However, there is also the view that commodity taxes would not be the right policy tool to separate entertainment and other goods. Commodity taxes can be used for efficiency reasons in order to stimulate labour supply and thus offset the distortions of the income tax on labour supply (Bastani et al., 2016). There is a need for further studies to better understand some of the aspects of taxing luxury goods and how it could affect inequality, tax administration and state revenue:

1) First, there is a need to draw a clear line which goods and when we can identify as a luxury, as there are social and cultural differences among countries;
2) Second, there is a need for more in-depth studies to understand which taxes are best to use as well as how to organize tax administration in open markets if there is no common tax harmonization;
3) Third, the methodology should be developed for luxury tax' estimation models per specific luxury goods.

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