To Tax or Not to Tax - This is the Question

By Sam Vaknin, Ph.D.

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To tax or not to tax - this question could have never been asked twenty years ago.

Historically, income tax is a novel invention. Still, it became so widespread and so socially accepted that no one dared challenge it seriously. In the lunatic fringes there were those who refused to pay taxes and served prison sentences as a result. Some of them tried to translate their platforms into political power and established parties, which failed dismally in the polls. But some of what they said made sense.

Originally, taxes were levied to pay for government expenses. But they underwent a malignant transformation. They began to be used to express social preferences. Tax revenues were diverted to pay for urban renewal, to encourage foreign investments through tax breaks and tax incentives, to enhance social equality by evenly redistributing income and so on. As Big Government became more derided - so were taxes perceived to be its instrument and the tide turned. Suddenly, the fashion was to downsize government, minimize its disruptive involvement in the marketplace and reduce the total tax burden as part of the GNP.

Taxes are inherently unjust. They are enforced, using state coercion. They are an infringement of the human age old right to property. Money is transferred from one group of citizens (law abiding taxpayers) - to other groups. The recipients are less savoury: they either do not pay taxes legally (low income populations, children, the elderly) - or avoid paying taxes illegally. But there is no way of preventing a tax evader from enjoying tax money paid by others.

Research demonstrated that most tax money benefited the middle classes and the rich, in short: those who need it least. Moreover, these strata of society were most likely to use tax planning to minimize their tax payments. They could afford to pay professionals to help them to pay less taxes because their income was augmented by transfers of tax money paid by the less affluent and by the less fortunate. The poor subsidized the tax planning of the rich, so that they could pay less taxes. No wonder that tax planning is regarded as the rich man's shot at tax evasion. The irony is that taxes were intended to lessen social polarity and friction - but they achieved exactly the opposite.

In economies where taxes gobble up to 60% of the GDP (France, Germany, to name a few) - taxes became THE major economic disincentive. Why work for the taxman? Why finance the lavish lifestyle of numerous politicians and bloated bureaucracies through tax money? Why be a sucker when the rich and mighty play it safe?

The results were socially and morally devastating: an avalanche of illegal activities, all intended to avoid paying taxes. Monstrous black economies were formed by entrepreneuring souls. These economic activities went unreported and totally deformed the processes of macroeconomic decision making, supposedly based on complete economic data. This apparent lack of macroeconomic control creates a second layer of mistrust between the citizen and his government (on top of the one related to the collection of taxes).

Recent studies clearly indicate that a reverse relationship exists between the growth of the economy and the extent of public spending. Moreover, decades of progressive taxation did not reverse the trend of a growing gap between the rich and the poor. Income distribution has remained inequitable (ever more so all the time) - despite gigantic unilateral transfers of money from the state to the poorer socio - economic strata of society.

Taxes are largely considered to be responsible for the following: They distorted business thinking; Encouraged the misallocation of economic resources; Diverted money to strange tax motivated investments; Absorbed unacceptably large chunks of the GDP; Deterred foreign investment; Morally corrupted the population, encouraging it to engage in massive illegal activities; Adversely influenced macroeconomic parameters such as unemployment, the money supply and interest rates; Deprived the business sector of capital needed for its development by spending it on non productive political ends; Caused the smuggling of capital outside the country; The formation of strong parallel, black economies and the falsification of economic records thus affecting the proper decision making processes; Facilitated the establishment of big, inefficient bureaucracies for the collection of taxes and data related to income and economic activity; Forced every member of society to - directly or indirectly - pay for professional services related to his tax obligations, or, at least to consume his own resources (time, money and energy) in communicating with authorities dealing with tax collection.

Thousands of laws, tax loopholes, breaks and incentives and seemingly arbitrary decision making, not open to judicial scrutiny eroded the trust that a member of the community should have in its institutions. This lack of transparency and even-handedness led to the frequent eruption of scandals which unseated governments more often than not.

All these very dear prices might have been acceptable if taxes were to achieve their primary stated goals. That they failed to do so is what sparked the latest rebellious thinking.

At first, the governments of the world tried a few simple recipes:

They tried to widen the tax base by better collection, processing, amalgamation and crossing of information. This way, more tax payers were supposed to be caught in "the net". This failed dismally. People found ways around this relatively unsophisticated approach and frequent and successive tax campaigns were to no avail.

So, governments tried the next trick in their bag: they shifted from progressive taxes to regressive ones. This was really a shift from taxes on income to taxes on consumption. This proved to be a much more efficient measure - albeit with grave social consequences. The same pattern was repeated: the powerful few were provided with legal loopholes. VAT rules around the world allow businesses to offset VAT that they paid from VAT that they were supposed to pay to the authorities. Many of them ended up receiving VAT funds paid the poorer population, to which these tax breaks were, obviously, not available.

Moreover, VAT and other direct taxes on consumption were almost immediately reflected in higher inflation figures. As economic theory goes, inflation is a tax. It indirectly affects the purchasing power of those not knowledgeable enough, devoid of political clout, or not rich enough to protect themselves. The salaries of the lower strata of society are eroded by inflation and this has the exact same effect as a tax would. This is why inflation is called the poor man's tax.

When the social consequences of levying regressive taxes became fully evident, governments went back to the drawing board. Regressive taxes were politically and socially costly. Progressive taxes resembled Swiss cheese: too many loopholes, not enough substances. The natural inclination was to try and plug the holes: disallow allowances, break tax breaks, abolish special preferences, eliminate loopholes, write-offs, reliefs and a host of other, special deductions. This entailed conflicts with special interest groups whose interests were duly reflected in the tax loopholes.

Governments, being political creatures, did a half hearted job. They abolished on the one hand - and gave with the other. They wriggled their way around controversial subjects and the result was that every loophole cutting measure brought in its wake a growing host of others. The situation looked hopeless.

Thus, governments were reduced to using the final, nuclear-like, weapon in their arsenal: the simplification of the tax system.

The idea is aesthetically appealing: all tax concessions and loopholes will be eliminated, on the one hand. On the other, the number of tax rates and the magnitude of each rate will be pared down. Marginal tax rates will go down considerably and so will the number of tax rates. So, people will feel less like cheating and they will spend less resources on the preparation of their tax returns. The government, on its part, will no longer use the tax system to express its (political) preferences. It will propagate a simple, transparent, equitable, fair and non arbitrary system which will generate more income by virtue of these traits.

Governments from Germany to the USA are working along the same lines. They are trying to stem what is in effect a tax rebellion, a major case of civil disobedience. If they fail, the very fabric of societies will be affected. If they succeed, we may all inherit a better world. Knowing the propensities of human beings, the safe bet is that people will still hate to see their money wasted in unaccounted for ways on bizarre, pork barrel, projects. As long as this is the case, the eternal chase of the citizen by his government will continue.

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Avoid Annuity Tax Problems

By Tony Novak

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Millions of investors own retirement annuity accounts but few are aware of the tax implications when the annuity is passed to an heir or beneficiary. A little known tax fact is that income tax on an individually owned annuity can be postponed only if the account owner’s spouse is named as the sole beneficiary. If the annuitant is not married, the same treatment may be obtained through the use of a trust account. Any other designation of the account beneficiary will cause the proceeds to be immediately taxable in the year of the account owner’s death. The results can be financially devastating, triggering huge current tax liabilities that would have otherwise been avoided. Most beneficiary designations are made at the time that the annuity account is opened, often without the advise of a professional tax adviser. The investment representatives who typically open these annuity accounts give the blanket recommendation to investors to “seek advise from your own tax adviser” but few investors ever bother to seek separate tax advice. Investors often assume that the financial planner opening the annuity account is incorporating tax advice into the service provided, but usually this is not the case. By the time the tax problem is discovered by the executor or the estate, it is too late to make any correction.

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