Abuse by Taxation

LAND & Liberty INTERROGATION
Income Tax

THE BICENTENARY of the income tax has slipped by almost unnoticed. Pitt the Younger introduced it in 1799 to finance the war with Napoleon.

As if to celebrate the event, the starting rate of income tax was cut this year to 10% by Britain's Chancellor, Gordon Brown. This returned the levy to its level of 200 years ago, when the law to tax incomes caused indignation because it required citizens to disclose how much they earned. This, admitted William Pitt, was "repugnant to the customs and manners of the nation". But that did not deter him, for the drift of fiscal history favoured the shift away from the Land Tax. Someone else had to pay (*see Box 1*).

Pitt's revenue-raiser yielded £6 million. Today it raises nearly £90 billion, more than a quarter of the British government's revenue, which is about the average for all OECD countries. The 10 pence rate removed many low-income earners from the tax net, but it also added yet one more layer of complexity to public finance. The Chartered Institute of Taxation reports that there are 7,657 pages of legislation covering direct taxes paid by the owners of small businesses alone.

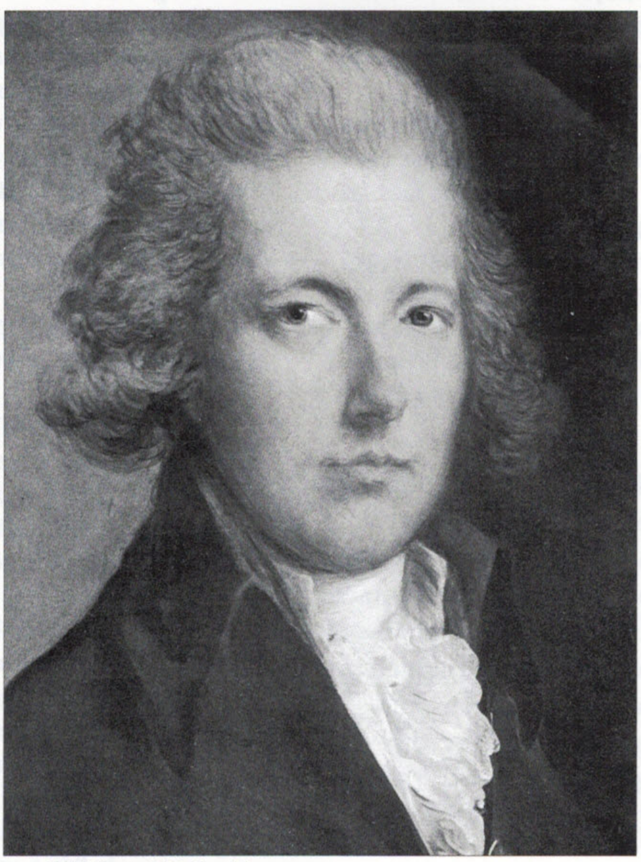
The passage of time has not endeared people to income tax. In the US, according to the official version, 17% of Americans refuse to pay income tax. The lowest compliance rate in recent history is matched by an Internal Revenue Service (IRS) bureaucracy of 102,000 employees. But despite the high level of public discontent, policy-makers continue to champion the tax.

LAW-MAKERS are locked in a double bind. They have to sympathise with angry constituents, but they also have to provide revenue to keep the nation-state operational.

The conventional view on the obligation to pay is put by a senior US Senator, William Roth Jr. As Chairman of the Senate Finance Committee, he wrote: "Taxation is a responsibility shared by everyone who enjoys the blessings of America. Those who refuse to contribute only place a greater burden on the rest of us."

That statement is not as simple as it seems. We can excavate complex assumptions which, if evaluated, would cause disarray in the philosophy of public finance. Politicians do not question the assumptions that steer their politics, because they prefer a quite life. But turning a blind eye to the anomalies of tax policy no longer appears to be an option. For governments are finding that, no matter how much they take out of their economies, they still do not have enough to fulfil the expectations of electorates. Is there a fundamental flaw in public finance which warrants forensic examination?

Roth himself chaired the most searching investigation ever into the IRS. He uncovered corruption on a massive scale. His committee documented how administration of the income tax drove people to bankruptcy, broke up families and even induced suicide (*see Box 2*).



■ **William Pitt the Younger**

That enquiry resulted in a law last year which seeks to control the taxmen who became a law unto themselves. But Roth did not examine the philosophy of income taxation. Had he done so, he would have been confronted with the sight of the most grotesque abuse of the principles of justice that underpin the US Constitution.

THE DAMAGE inflicted on the economy by income tax is of monumental proportions.

Politicians know this to be the case. As Roth put it: "The income tax itself is a dichotomy. While the power to tax is the power to destroy, it is equally true that taxes are what we pay for a civilised society". The problem for democratic governance is to identify revenue raisers that can yield sufficient income but are free of the "power to destroy".

Economists are reluctant to quantify the losses in terms that are accessible to the public. That kind of information would be political dynamite! One solution is to ignore the problem altogether (the response of politicians). Another is to claim that the challenge of adding up the losses is too complicated (the response of economists).

This is unsatisfactory for concerned citizens like Maurice Saatchi, co-founder of the Saatchi & Saatchi advertising empire who was elevated to the peerage in 1996. He and Peter Warburton, an investment banker, view the centenary of the income tax as a call for a War of Independence against what they call the No.1 problem of the 21st century – "taxes are always going up, yet the government never seems to have enough money to spend on good things like health and education". They want to reduce the tax-take to levels that existed 30 years ago.

But they have a problem, as they explain: "Excessive government interference in the production process or the pricing mechanism creates distortion and inefficiency, lowering the potential size and growth of the whole economy. Yet these arguments are difficult to prove: empirical studies in numerous individual countries have laboured to establish their validity. There are so many variables that are beyond experimental control that it is difficult to disentangle the various economic effects".*

So they take comfort in the annual exercise conducted by the Vancouver-based Fraser Institute. Its Index of Economic Freedom includes things like the size of government,

* Maurice Saatchi & Peter Warburton, *The War of Independence*, London: Centre for Policy Studies, 1999.

structure of the economy, security of property rights, viability of contracts and freedom of exchange in capital and financial markets. Last year Hong Kong topped the index, with a score (out of 10) of 9.6, followed by Singapore (9.4), New Zealand (9.2), US (9.1) and the UK (9.0).

Saatchi and Warburton interpret that evidence as supporting the theory that "individual prosperity is considerably greater in liberalised economies". But the elements of that index do not offer policymakers concrete guidance. Why, for example, is Hong Kong the consistent winner of such comparative studies of freedom? Could it be the distinctive source of public revenue (a heavy reliance on rental income, which makes possible very low rates of taxation)? Without answers to such specific questions, it will be difficult to build a consensus around the conclusion favoured by Saatchi and Warburton: that governments should reduce their tax-take.

Table 1: Gain in Output and Per Capita Income from switch to the Rent Revenue Policy (1993)

	NDP $ bn	NDP per capita $
USA	1,602	6,902
Canada	275	9,142
France	879	15,166
Germany	1,018	12,406
Italy	815	14,128
Japan	1,535	12,284
UK	716	12,133
Total	6,840	

Source: Fred Harrison (ed.) *The Losses of Nations*, London: Othila Press, 1998, p.vi.

But that throws the question back to the estimation of the deadweight losses of specific taxes, which then need to be added up. Saatchi and Warburton are pessimistic about being able to execute such an exercise. That pessimism is unwarranted. Economists at Virginia Polytechnic Institute and State University have started to refine a model that yields estimates of the negative impact of conventional taxes (*table 1*). The yardstick against which to assess the scale of losses? They compute the productive capacity of the economy if government employed the benign policy for raising revenue (charges on the flow of land and resource rents). According to their calculations, the US is now losing nearly $2 trillion a year for no better reason than that Congress insists on employing taxes that favour landowners and penalise the working population!

IN MODERN history, Pitt played a leading roll in the shift of taxation in favour of the owners of land. In Britain, the Liberal government of 1905 tried to reverse the trend, but landlords in the House of Lords fought tooth and nail to prevent the reintroduction of a dedicated land tax. Their victory set the scene for the 20th century trend, which was to untax wealth and penalise people's earned incomes (*table 2, page 6*).

BOX 1

The Land Tax & Pitt the Younger

WILLIAM PITT (1759-1806) was appointed prime minister of Britain in 1783, at the ripe old age of 24. From the outset, he was determined to consolidate the political dynasty established by his father, Pitt the Elder, who taught his son the facts of life about power. The basis of that power was land.

From his estate in Somerset (rental income: between £3,000 and £4,000) a year, Pitt the Elder allowed his imagination to roam beyond the landscape and into the ethereal sphere of history.

The estate "provided the kind of base that counted in the country, the landed position which sustained a political family; and it had fallen to him in a manner peculiarly appropriate to his conception of his career. It was perhaps no coincidence that he claimed a peerage at the first opportunity, as Earl of Chatham and Viscount Burton Pynsent," wrote biographer John Ehrman.

His son took high office for granted. Pitt the Younger's attitudes were shaped by his father. "His pleasures remained largely those of his father: he rode, he farmed when time allowed, above all he followed Chatham's favourite pastime of landscape gardening," notes Ehrman in the first of the definitive 3-volume biography of Pitt the Younger.

So when young Pitt was faced with the financial challenge of financing the war with Napoleon, he did not increase the Land Tax. In a new biography by Eric Evans, the Professor of Social History at Lancaster University, the social context of those who exercised power in London was pithily described in these terms:

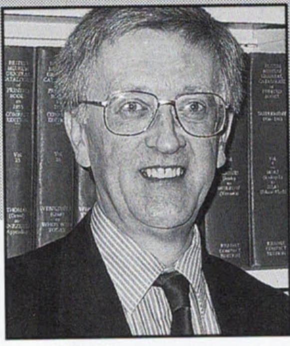
"Pitt's solution was to levy a new tax on income and to phase out the land tax, long hated by suspicious landowners who argued that 'the monied interest' has been unwarrantably advantaged by the tax system".

In 1799, Parliament introduced a 10% tax on all income over £200 a year, with lower rates for incomes above £60.

English fiscal history is full of precedents for Pitt's action. Walpole, for example, prepared to re-impose the Salt Tax in 1732 as a substitute for the Land Tax. The Salt Tax had been repealed two years earlier as the most suitable way of relieving the poor. Walpole claimed that reinstating the Salt Tax was fair between rich and poor, contending that everyone should pay tax since everyone shared the benefit of public services. A pamphlet supporting Walpole argued that if the labourer "has no estate, yet he owes the protection of his life and liberty to the Government and should consequently contribute his mite to its support". This blatantly ignored the feudal theory that rent paid by labourers to landlords should be used to defray the public services of the kingdom – i.e., labourers DID pay for the benefits of protection of life and liberty. The business of the politicians, however, was to convert that social rent into private income.

SOURCES:

John Ehrman, *The Younger Pitt*, London: Constable, 1969.
Eric J. Evans, *William Pitt the Younger*, London: Routledge, 1999.
Kenneth Jupp, *Stealing our Land*, London: Othila, 1997.
William Kennedy, *English Taxation 1640-1799*, London: Bell, 1913.



■ **Eric Evans**

That people resent this fiscal history is evidenced by evasion of taxation, of work and of investment, which distorts the economy. Thus, the systemic flaw can be corrected only by shifting the structure of public finance back onto resource rents. That would put history in reverse. Is that possible? Given the massive losses inflicted by conventional policies, the pertinent question is: Do we have a choice?

The damage is not limited to material losses. Cultural impoverishment cannot be quantified by economists' models. In the 1950s, for example, Americans discovered that the tax system nourished "widespread misconduct, including bribery, embezzlement, influence peddling, and rampant conflict of interest," as Roth put it. Taxation's corrosive impact on morals is illustrated by the way the public in general condones tax-dodging, which is akin to a popular sport. But isn't it wrong to avoid paying for public services? The answer depends on assumptions about citizenship and property rights, and on the level of analysis that is applied. A good case can be mounted for arguing that there is no such thing as tax evasion – if the test is the one applied by Roth: people should pay for enjoying "the blessings of America".

People are not fools. They know that when they buy or rent residential or commercial property they pay for "the blessings of America". For the rent (or its capitalised form, the selling price) is a precise measure of the value of the benefits they would derive from using natural and/or public services in the locality. People rent or buy their way into the services they want from

America. That is what their lease or mortgage is all about.

This is where the psychological and moral problems begin. For *tax-dodging renters willingly pay for the public services they need!* They do not pay the government. They pay their landlords, who collect the rent without paying for the services! Is it the renters' fault that government fails to collect the rents from landlords?

Table 2: UK tax structure: % of revenue

	Income taxes on individuals	Expenditure taxes	Company taxes	Wealth taxes on individuals
1908-9	26.8	49.6	1.6	0.5
1998-9	37.3	44.3	14.6	3.8

Source: Inland Revenue Statistics 1998

This outcome gives rise to enormous economic and sociological stresses.

- **In the labour market**, people are constantly searching for ways to avoid taxes. Workers whose services are in high demand, such as programmers in the computer industry, can persuade employers to collude with them. In Britain's information technology sector employees are converting to contract workers to collect remuneration in the form of dividends. The Treasury calculates that this is costing the Exchequer £450m a year in lost income tax.
- **In the political arena**, there is a perpetual feud between cash-strapped governments and people who implicitly object to paying twice for the delivery of one set of services: first, when they buy or rent those services from property owners in the market, and again when the taxman appropriates their wages.

Such tensions are traced back to bad policy, for which government is responsible. By failing to raise revenue direct from land-rent, government is obliged to resort to the damaging methods of raising revenue.

A RADICAL review of public finance would be socially cathartic. For the terms of such an enquiry it would be difficult to improve on the words of Edward I, the English king who said: "To each his own! We must find out what is ours, and due to us. And others, what is theirs, and due to them".

What the kings and barons of old regarded as theirs, of course, was determined over the heads of common people. Their tussle was for control over the taxable surplus of the economy. To appropriate that revenue they had to control the nation's territory and the estates of which it was composed. Land was what it was all about, because the taxable capacity of the nation was its rental income.

Nothing has changed. The taxable surplus is denoted by the rent of land and natural resources. Today, that economic reality is camouflaged by the outcome of the savage historical struggle for power over rent. That struggle became the pathology of high politics, which in turn necessarily became (because the field of combat was the taxable surplus of the nation) the pathology of public finance.

The symptoms of that pathology are displayed in many forms. One is the money merry-go-round. In Britain, government collects between £30-40 bn in income tax and national insurance contributions from 17m households which then receive the money back as "benefits".

People accept the need to pay for public services. But, intuitively, they sense a crippling flaw somewhere. That flaw is likely to be in the nature of taxation, which is defined by the OECD as "a compulsory, unrequited payment to general government". By unrequited they mean "benefits provided by government to taxpayers are not normally in proportion to their payments". People happily pay for what they get. They do not like paying for what they do not receive.

In the days of divine rights, the kings and barons finally settled the conflict over who owned what, and the commoners were the losers. The battle now has to be fought all over again, but this time the weapons are the tools of democratic discourse.

BOX 2

Terrorising Tax Power

A CULTURE of secrecy turned the US tax-collecting agency, the Internal Revenue Service, into a ruthless system for terrorising citizens. According to US Senate Finance Committee chairman, William V. Roth, Jr.: "Many innocent taxpayers, denied due process and living lives on the edge of financial ruin, were forced and even bullied into paying more taxes than they owed, and the perpetrators of this abuse were being promoted, given cash awards, and allowed to carry on within a federal agency that is shrouded in more secrecy than the CIA".*

Prior to September 1997, when Senator Roth launched hearings, the IRS had not been subjected to the full glare of publicity in a thorough investigation into its methods. For decades, the IRS deployed power which corrupted some of its employees to the point where citizens were driven to despair by illegal methods and harassment.

It began in 1862 when Abraham Lincoln levied the first American income tax to finance the civil war. Although the supreme court was to rule it as violating Article 1, Section VIII of the Constitution, in 1913 Congress passed the Sixteenth Amendment to permit a "direct" tax.

In 1955, following disclosure of rampant corruption, the Bureau of Revenue changed its name to the IRS. But the name change did not work: the wolf was still within. And the IRS went on to consolidate its powers in secret. This it justified with an astonishing doctrine: public disclosure of its methods was not in the public's interest, because it would weaken the IRS's ability to raise revenue! Sen. Roth interpreted this doctrine thus:

"This line of reasoning holds that people are frightened by what they don't know, by what they can't see and understand. Fear leads to submission. Frightened Americans will more readily pay their taxes".

Congress, driven by a tax-and-spend mentality, allowed the IRS to get away with proverbial murder. Even "Senators and congressmen have been threatened and intimidated. The agency has even retaliated against its own commissioners and employees," reveals Senator Roth.

But the senator's hearings failed to ask the searching questions about the foundations of income taxation. Although he brandishes the concept of equity – "there's no excuse for those who refuse to pay their fair share of taxes" – in his book he does not challenge the basis on which congress appropriates earned incomes. He does censure "overbearing taxation and runaway federal spending", but he does not identify principles that would guide government on questions of

- how much should be raised,
- the method of raising revenue, or
- the sources from which it should be raised.

So no criteria are provided for judging whether he is correct in saying that Americans are excessively taxed: "We have an income tax, something Americans aren't too fond of in the first place. Seventy per cent believe it's excessive. It's applied by a code so complex that on April 15 most folks don't know whether they're cheats or martyrs".

The Revenue Act of 1913 introduced the income tax. It took up 14 pages in the law books. Today, the law runs to 4,100 pages, with an additional 5,000 pages of regulations. The original tax applied to less than 1% of the population – about 357,000 of the wealthiest people – and applied to all income "from whatever source derived". Today, more than half of all income is subject to the tax.

■ **William V Roth Jr**

* William V. Roth, Jr. & William H. Nixon, *The Power to Destroy*, New York: Atlantic Monthly Press, 1999.