SOCIETY OF ACTUARIES

Investment Section

INVESTMENT FALLACIES 2014

The "Dollar Bill" Fallacy

by Gary Thomas

Taxes can be applied in many different ways. Some taxes are applied as flat fees (on fishing licenses for example) while others such as highway tolls are loosely tied to the distance driven. Sales taxes and customs duties are generally applied to the value of the product while taxes on property and personal assets are also some function of the value of the property. In all these cases, we instinctively understand how such taxes are applied and arrange our lives accordingly. Furthermore, the formula used to levy these taxes tends to be uniformly applied and doesn't often change.

In contrast, taxes on income tend to be controversial, partly because we all have different types and amounts of income and have strong views about who is more deserving. Also, since these taxes are not uniformly applied, higher taxes for your neighbor might mean lower taxes for you! Policy arguments in this high stakes game are often couched in terms of "fairness".

Because income taxes tend to be applied directly to each marginal dollar of income and one dollar looks very much like any other dollar, it is easy to fall into the fallacy that it is the dollar itself that is being taxed, and not the activity. This "dollar bill" fallacy shows up in several widely repeated arguments related to income and taxes.

The first application of the dollar bill fallacy arises when people take a dollar and follow it through two serial events. We see this in the assertion that estate taxes count as "double taxation" on the grounds that the dollar had been previously taxed when earned as income. We also see this so-called double taxation with corporate dividends when investors are taxed on dividends that have already been subject to taxation as corporate income.

In order to analyze these situations more clearly, it is helpful to take our eyes away from the dollar bill and to look instead at the separate decision points along the way. Every time a dollar passes through a different decision point, the tax at that point has to be evaluated separately from the taxes at other decision points.

Let's look first at estate taxes. After a dollar of income has been taxed, there are a lot of different things that can be done with the remainder – it can be spent or perhaps saved or invested. In all these cases further taxes may be applied. The decision to earn the money is entirely separate from the decision on how to dispose of it. Likewise, estate taxes are not inevitable, but the result of a conscious choice not to spend everything prior to death (that's why they call it estate planning!). Clearly, the thought of paying tax for simply dying must sting; however, in a free country each person chooses their own path in full knowledge of the tax consequences for each step along the way.

A similar perspective can be applied to double taxation of corporate dividends. Each nation can set the taxation of investment earnings of its citizens and it can also set the taxation of its corporations. Citizens of one country are at liberty to invest in shares of corporations from another country. The decision of a corporation to domicile in a country is entirely separate from the investment decisions of its shareholders living in different countries. Indeed, the recent public struggles of governments to figure out how to properly tax Amazon, Apple and other non-traditional companies provide evidence that there is nothing inevitable about this double taxation.

A second, and perhaps more important, application of the dollar bill fallacy arises when considering the appropriate tax rates to apply to different types of income. This issue received widespread attention during the last US presidential campaign when Mitt Romney's 15% tax rate on capital gains was compared to the 35% tax rate supposedly paid by Warren Buffett's secretary. In the eyes of many commentators this was immoral and inequitable and justified the 3.8% increase in the capital gains tax rate that had been used to help fund Obamacare.

But let's look a little more closely at these types of income; as before, the dollars may look the same, but the decisions, effort and risks involved in earning them clearly can be quite different for an investor and a worker, and the application of the two tax rates isn't quite apples to apples.

Firstly the risks associated with different forms of income are not at all comparable. An investor is often taking significant risk that they may not only fail to make any investment income, but may even lose some or all of the investment itself. In contrast, most wage earners know exactly how much they will earn when they walk into work each day; and while some salespeople might not make any commissions at all, they certainly do not run the risk of actually losing any of their own money.

Secondly, a significant component of investment income is comprised of inflation and this is also taxed. According to The Tax Foundation, this hidden tax had the effect of driving up the effective capital gains tax rate on investments since 1950 from an average of 26.4% to 42.5%. Indeed, to take an extreme case, a purchase against the S&P500 index in July 2000 would yield a nominal taxable gain of 18% by July 2013 but a loss in real terms, so that the tax rate was effectively infinite.

Investors must also consider the costs involved in holding investments. A 1.5% annual fee in an actively managed mutual fund would eat away 24% of the value over a 20 year period. Not only does this reduce the potential gains, but it also increases the possibility of a loss.

Against all this, a worker's income requires hard work and a substantial time commitment.

It can be seen from the above that "fairness" is an elusive concept when trying to determine the appropriate level of taxes on investment income relative to taxes on salaried income. Does it matter whether the average person understands these differences and appreciates that the effective inflation-adjusted capital gains tax rate is actually much higher than advertised? Perhaps not, although it is clear that the investor class understands. So how would we expect them to react?

This brings us to a big difference between investors and wage earners – their behavior in response to taxes and other stimuli. The average wage earner will generally keep doing the same job in order to pay down their house, support their family and save for retirement no matter how much tax rates may move. But many investors have significant discretion as to whether to invest and how.

When making an investment decision, an investor will evaluate their potential return net of expenses, inflation and taxes and decide whether the return warrants the risk. If it doesn't, then they may choose to favor current spending over investments and future spending. They could buy more goods and services, take more vacations or perhaps put their money in things that hold their value and can be enjoyed now like art, collectibles and property.

Surely all this current spending would be plowed back into the economy? Yes it might, although there is a big difference between money that is invested in new companies, new factories, and new technology and money that is spent on yoga instructors, gardeners, and maids. One builds the economic infrastructure of a country and the other one doesn't. In the extreme case, potential investors might even choose to take themselves and their wealth out of a country and employ it elsewhere. This has recently happened most notably in France (in response to punitive tax rates) and even in the US where the number of citizenship renouncements

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have hit an all-time high. In the case of both countries, the numbers may be small but the message is unmistakable.

Clearly, decisions to invest can have a significant and positive impact on society since they can lead to job creation and economic vitality. The mobility of capital in the modern world makes it quite responsive to incentives, and governments everywhere are sharpening their pencils as they figure out exactly what they want to tax and how to make their societies both fair and efficient. It is worth noting that a number of countries encourage investment by allowing workers a limited amount of investment earnings free of income taxes. So there is little doubt about the importance of investing.

So how do we move forward? Economic activity requires application of both labor and capital. The dollar bill fallacy is distorting thinking on several aspects of investing; continued use of faulty logic will lead to sub-par outcomes. If we want to start thinking properly about investment incentives and taxation, then the first step is to move past the dollar bill fallacy and start thinking about how people actually make decisions and respond to incentives. If we don't do it, others will.

Gary Thomas FSA, MAAA is an Assistant Director, Long Term at Bermuda Monetary Authority. He can be reached at *GThomas@bma.bm*.

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