

## TAXATION – Part 2 – SECURITY CONCERNS.

### A top-down approach to risk mitigation ...

by Vic Berecz

A few weeks ago, I said the first-and-foremost goal of our tax system is to “provide us the security needed to live in relative freedom in our community.” On that I’m sure all Americans agree. A little thought leads to the conclusion that this is a classic *risk management* problem ... one of the reasons we pay taxes is to pay for the things which mitigate risks to our security and freedom ... risks like hostile armies, terrorists, natural disasters, fires, thieves and many, many others. Four years ago, in the wake of Hurricane Katrina, I wrote a piece titled “The Enigma of Risk Management.” It’s conclusion was that *IT IS IMPOSSIBLE TO ELIMINATE ALL DANGERS ... the best we can do is MITIGATE SELECTED THREATS.*

Risk management involves identifying risk factors (in this case *security threats*), estimating their probability and potential impact (cost, lives, etc.) and planning cost-effective approaches to mitigate (ie. reduce the probability of occurrence and/or severity of) selected risks. For instance, houses catch fire. The probability of that happening to your house in your lifetime is perhaps 10%. Say your house is worth \$200K. Without a Fire Department, in most fires the house will be a total loss. So, on average, you are potentially at risk for a loss of \$20K to house fires. With a Fire Department the loss might typically be one-quarter of that. Maintaining a Fire Department is a risk mitigation approach which reduces the average potential cost of an occurrence (in addition to saving lives). Is it cost-effective? Yes, if you spend much less per household on the Fire Department than the average \$15K savings resulting from this risk mitigation approach. That’s called *bang-for-the-buck* or *pay-back*. If we anticipate insufficient payback, we’ll likely choose to forego mitigation of that specific threat.

Unfortunately, risk mitigation is the classic *Catch-22*. If no fires happen, folks complain about wasted taxes supporting all those firemen sitting around “with their elbow in their ear.” If a house burns to the ground, folks complain about the wasted taxes supporting all those firemen who didn’t do their job. Few people notice that most fires are put out quickly as a result of the difficult and sometimes heroic work of the fire department. Whether it’s security threats, business issues, or technology, when it comes to risk management ... it seems there’s no winning!

Because probabilities are involved in all risks, there is no *right* amount to spend on risk mitigation. But, spending nothing pretty-much ensures eventual calamity. Spending a lot pretty much ensures no *bang-for-the-buck* expended. So the answer to how much we should spend on risk mitigation is somewhere in between, and rather arbitrary. That’s the way most corporations deal with it. Plan a major project and add an arbitrary percentage of the estimated “best-case” cost for risk mitigation. Typically that was 3 to 5% in the major software development projects I planned. If you don’t like those numbers, choose others ... as I said, the decision is arbitrary!

I propose we do the same thing when we budget funds for national risk mitigation to confront security threats. But, 3 to 5% “of what” you ask? GDP – our national gross domestic product. That’s the sum-total of what’s potentially at risk, so why not? I know, that’s a whole lot of money. But, isn’t our freedom and security worth it? Please note that this is much less than the almost 12% we spent on “risk mitigation” during World War II. We must therefore remember that in such times of crisis more than the normal allocation of funds will be needed ... but we can’t let ourselves fall into the trap of being in *perpetual crisis*.

Obviously there are risks best dealt with centrally (keeping “rogue nations” at-bay) and others best dealt with locally (fighting house fires) and some are best shared. Therefore, planning is needed to enumerate major classes of risks, estimate roughly their relative cost and importance, and allocate them between the national and local (state, etc) governments. A non-partisan national planning council (similar to the CBO) with state representation might be needed for this task. As with all planning, you follow-up with re-planning as actual data becomes available, so you’re ready for the next budget cycle. For argument’s sake ... let’s halve the risk mitigation budget and decree that’s how much the Federal government will spend on risk management. Then, that’s how much we need to collect in federal taxes to meet our national security needs.

Now, what about the other half. I think each state ought to deal with that in it’s own way. The plan (and other constraints, such as our *Constitution*) have identified what local government is responsible for. If I were to do local planning, I’d take the same top-down approach starting with the state’s GDP. Then I’d allocate the various risk mitigation approaches between the state and the various lower-level local governments. Finally, each local-government entity would produce budgets and their respective taxing requirements.

OK – let’s say you “buy” everything I’ve said above. But, you’re unhappy with the approach of the community to mitigating certain risks that trouble you. Assuming you have the means, you are free to undertake additional risk mitigation approaches for yourself and your family. People do that all the time: they purchase cars with expensive safety features ... they buy insurance ... they own firearms ... they take karate lessons ... they live in *compounds* in the boonies ... whatever suits their fancy. Just don’t mess with my freedoms and security or impugn the motives of the majority who have established our nation as a community with levels of freedom and security with which they as a whole are comfortable.

Note that I have not addressed the question of how to collect taxes to pay for this level of security ... or even whether they would be more or less than in our current taxation system. For now I’m concentrating on identifying the things for which most of us are willing to pay taxes. Today, I’ve described a top-down risk mitigation approach to security threats that should be shared between the national and local governments. That ...

**... is my proposal. What are your thoughts?**

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