

Historical Perspective: What You Don't Know Can Hurt You

by Joseph J. Thorndike

Tax Notes columnist Joseph J. Thorndike addresses tax withholding and the benefits of tax consciousness.

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Milton Friedman doesn't like withholding. Speaking before President Bush's Advisory Panel on Federal Tax Reform recently, the Nobel Laureate and conservative icon urged members to dismantle this pillar of the modern tax system. Collection at source undermines tax consciousness, he insisted, obscuring the cost of government and curbing individual freedom.

Friedman has reason to know. As a young Treasury economist in the early 1940s, he helped design the withholding system. Before World War II, each year's tax bill had been due and payable in quarterly installments the following year. Officials worried that new taxpayers -- including millions of middle-income individuals added to the rolls in 1941 and 1942 -- would fail to set aside enough money. Wholesale default seemed imminent.

Withholding was the logical solution. Social Security taxes, introduced in the late 1930s, had demonstrated the practicality of this administrative innovation. And despite opposition from the Bureau of Internal Revenue (whose leaders never seemed to encounter an innovation they liked), Treasury officials -- including Friedman -- urged lawmakers to adopt the idea. After a protracted and public debate, Congress agreed.

Today Friedman bemoans the effect of that wartime decision. "We gave next to no consideration to any longer-run consequences," he recalled in his 1998 memoirs, *Two Lucky People*. "It never occurred to me at the time that I was helping to develop machinery that would make possible a government that I would come to criticize severely as too large, too intrusive, too destructive of freedom."

For Friedman and other champions of limited government, withholding makes things entirely too easy. By insulating the taxpayers from their tax bills, it vitiates the bonds of healthy fiscal stewardship. After all, how can we starve the beast if we don't know how much we're feeding it?

Refunds are especially pernicious, according to many conservative thinkers. Economist Bruce Bartlett has suggested that the wartime introduction of withholding served to distort the way Americans think about their taxes. "Instead of being painfully aware of the size and burden of their annual tax bill," he said, "they began to look upon their annual filing exercise as an opportunity for a refund. Indeed, despite the fact that they are only getting back taxes that had been overpaid, many Americans view their refunds as found money, windfalls akin to winning the lottery."

Some conservative leaders have used tax consciousness to bolster their case for fundamental tax reform. Former House Majority Leader Dick Armey once suggested his flat tax be paid in monthly installments. And champions of a national sales tax fairly salivate at the prospect of a retail revolt: If Americans had to pay the bill for big government every time they walked up to a cash register, just imagine the outcry!

The antiwithholding argument is easy to caricature, especially in its more extreme forms. "The income tax allows the government to confiscate the wealth of its citizens," said Laurence M. Vance in a recent article for the Ludwig von Mises Institute. "The curse of the withholding tax is that it allows the government to commit this crime systematically, effortlessly, painlessly, and benevolently."

Such rhetoric notwithstanding, tax visibility is not solely a conservative idea. Even Franklin Roosevelt endorsed it, first as he struggled to fund the New Deal and later during the fiscal crisis of World War II. In fact, FDR used visibility to argue against sales taxation, insisting that income taxes were more straightforward.

Roosevelt had the courage of his convictions. He believed Americans would foot the bill for economic reform, even when confronted with its true cost. To be sure, FDR was no slouch when it came to fiscal obfuscation, and he wasn't averse to a certain amount of hidden taxation: The New Deal was funded in large part by regressive consumer taxes on alcohol and tobacco.

But Roosevelt understood that progressive government couldn't be funded forever on the sly. If the New Deal were to remain a fixture of American society, it would have to draw its sustenance from a tax system marked by honest, visible taxes.

Today those sentiments seem almost quaint. Most liberals have abandoned FDR when it comes to tax visibility. How else to explain the long-term growth of Social Security payroll taxes, a monument to fiscal expedience? Progressive politicians, perhaps wisely, seem to have concluded that regressive but unobtrusive taxes are better than progressive but visible ones.

Conservatives, too, seem conflicted when it comes to tax consciousness. Some, like Friedman and Armev, seem to relish the prospect of administrative complexity. Unhappy with the easy efficiency of withholding, they long for a more cumbersome era.

At the same time, many of those conservatives complain that taxes are already too complicated and administratively burdensome. Advocates of the flat tax, for instance, have long promised to reduce tax returns to the size of a postcard. And the large exemptions built into many tax reform plans hold out the prospect of a dramatically narrower tax base, with millions of taxpayers swept off the rolls.

There are good reasons, of course, for exempting poor Americans from the income tax. If we can save the country -- and the IRS - - from a lot of unnecessary paperwork, so much the better.

But those efficiencies come at a cost. Midcentury lawmakers were aware that income taxes on poor and lower-middle-income individuals might cost more to collect than they would ever raise in new revenue. But they believed tax consciousness was worth the price.

Of course, there are many ways to increase tax consciousness, and not all involve a heavy new burden for taxpayers. In a recent article in *The Canadian Journal of Law and Jurisprudence*, Tulane University Law Prof. Marjorie Kornhauser suggests taxpayers receive an annual statement from the IRS, akin to the statement they already get from the Social Security Administration. The tax statement would provide information on taxes paid, deductions taken, and relevant comparisons with the previous year. It would also provide aggregate statistical data, helping taxpayers make sense of their individual numbers.

Liberals may well be leery of that full disclosure, especially given conservative enthusiasm for tax consciousness. But progressive policymakers should think twice before ceding this important ideological ground. Is it really a good idea to gamble the future of progressive politics on the inattention and ignorance of American voters?

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