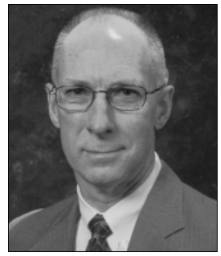
Wartime Origins of Modern Income-Tax Withholding



BY ROBERT HIGGS

Wars have always been the most important occasions for the introduction of new forms of taxation. At the outset of a war the state suddenly needs greatly increased revenues to pay for personnel and matériel to prosecute the war. Although governments typically increase the rates of existing explicit taxes and raise the rate of the hidden "inflation tax" by abruptly augmenting the money stock, these measures often prove insufficient, and other means must be devised to extract resources from the public quickly. One way to capture more revenue is to reduce tax evasion by seizing the people's earnings before the earners ever lay hands on them. This procedure has come to be known as tax withholding at the source, or simply withholding.

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Precedents for withholding U.S. taxes go back as far as the War Between the States, when the Treasury withheld taxes owed by federal employees under the income-tax law adopted in 1862 until an 1864 amendment exempted federal salaries from taxation. The war-spawned income-tax law was repealed in 1872, and an income-tax law enacted in 1894 was quickly declared unconstitutional (but not because it taxed wages and salaries). Immediately after ratification of the Sixteenth Amendment and passage of income-tax legislation in 1913, taxes were withheld at the source. This system provoked so much complaint from employers, however, that even the secretary of the treasury, William Gibbs McAdoo, recommended its elimination, and in 1917 Congress withdrew its authorization. After passage of the Social Security Act in 1935, the payroll taxes it authorized were collected at the source, but income taxes still were not.

Before World War II individuals who owed federal tax on their income earned in a particular year paid the tax during the following year in quarterly installments. In those days relatively few people paid income taxes. As late as 1939 fewer than four million individual returns were filed, and the filers' total tax bill came to less than $1 billion, or less than 4 percent of their net taxable income. When so few people paid income tax and the amounts due in most cases were so small, the system of deferred payment imposed no great burden and gave rise to few taxpayer complaints.

Beginning in 1940, however, the tax burden increased enormously. As the government began to mobilize for participation in a gigantic global war, its revenue demands grew apace. Federal spending burgeoned from $9 billion in fiscal year 1940 to more than $98 billion in fiscal year 1945. Although the greater part of this spending upsurge was financed by borrowing, huge increases in tax collections also took place. In 1945, 50 million individual income-tax returns were filed, and the filers owed more than $19 billion, or almost 20 times the amount that Americans had coughed up for this tax just five years earlier.

Milton Friedman was an economist at the Treasury during the early part of the war. In his 1998 memoirs, *Two Lucky People*, written with his wife Rose, he observed: "It was clear to all of us at the Treasury, as we set out to multiply the amount of revenue to be collected from the personal income tax, that it would be impossible to do so unless we could develop a system to collect the taxes as the income was earned, not a year later."

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The main problem connected with switching to a "pay-as-you-go" system was that when the switch was made, the taxpayers would have to pay two years' taxes in a single year—the amount due under the old system on the previous year's earnings and the amount due under the new system on the current year's earnings. Apart from the vociferous complaints such double-taxation was sure to produce, many people would simply be unable to make all the payments, especially when tax obligations were being increased drastically.

The transition problem sparked a great deal of debate in the government and among the public. Perhaps the leading proposal in 1942 came from Beardsley Ruml, the treasurer of R. H. Macy & Co., who was also the chairman of the Federal Reserve Bank of New York. Ruml proposed to "forgive" the previous year's tax liability completely when the switch to the pay-as-you-go system was made. The Treasury objected to allowing such a great amount of "forgiveness" and proposed an alternative, less-forgiving design.

After more than a year of wrangling in the bureaucracy and in Congress, the Current Tax Payment Act was signed into law on June 9, 1943. It provided for a complicated partial-forgiveness transition. As Friedman described it, the law basically "canceled . . . one year's tax obligations of $50 or less and 75 percent of the required tax on the lower of 1942 or 1943 income, requiring the remaining 25 percent to be paid in two equal annual installments." After the system became fully operational, employers withheld almost $8 billion for income taxes in 1944 and more than $10 billion in 1945.

Charlotte Twight, in a revealing chapter of her 2002 book, *Dependent on D.C.*, shows that during the extended debate that preceded passage of the withholding law in 1943, its proponents used various tactics to misrepresent its workings, its consequences, and the government's reasons for seeking it. In particular, she documents that "the tax 'cancellation' was a sham and was understood to be a sham by a significant number of government officials involved in its passage."

The withholding system has remained in effect continuously ever since 1943, even though the war that prompted its creation ended 62 years ago, and the system's perpetuation has contributed greatly to nourishing the postwar Leviathan state. As Twight says, "Withholding is the paramount administrative mechanism that since 1943 has enabled the federal government to collect, without significant protest, sufficient private resources to fund a vastly expanded welfare state."

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Reduces Taxpayer Awareness

The Treasury itself publicly acknowledges, in a fact sheet on the history of the U.S. tax system posted at its website, that wartime withholding not only "greatly eased the collection of the tax," but "also greatly reduced the taxpayer's awareness of the amount of tax being collected, i.e.[,] it reduced the transparency of the tax, which made it easier to raise taxes in the future." Some evidence: in 2005 more than 130 million individual income-tax forms were filed, yielding the federal government $1,108 billion in revenue, and of that amount, $787 billion, or 71 percent, came from withholding.

Friedman, who admitted being "one of the architects" of the Treasury's proposal for a withholding system, correctly noted in his memoirs that the system "would have been introduced had I been involved or not." Withholding was an essential element of the government's wartime revenue grab. "At the time," concluded Friedman, "we concentrated single-mindedly on promoting the war effort. We gave next to no consideration to any longer-run consequences. 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. Yet, that was precisely what I was doing."