

EVOLUTION OF FEDERAL INCOME TAX WITHHOLDING: THE MACHINERY OF INSTITUTIONAL CHANGE

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Taxes are the backbone of any politico-economic regime. Constraints on a government's power to tax are constraints on its power to act. Focusing on the legalization of mandatory federal income tax withholding through the Current Tax Payment Act of 1943, this article examines forces that have eroded constraints on the U.S. government's power to tax.

The central questions this article seeks to answer are how, why, and to what effect—despite preponderant public opposition to universal income tax withholding between 1914 and 1942—mandatory withholding was established in 1943, and sustained thereafter. It is an important question, for withholding is the paramount administrative mechanism enabling the federal government to collect, without significant protest, sufficient private resources to fund a vastly expanded welfare state. U.S. government officials themselves now view withholding as “the cornerstone of the administration of our individual income tax” (U.S. House Ways & Means Comm. Hearings 1982: 162, 165). This article explores (1) historical conditions that led people to accept withholding of federal taxes on wage and salary income; (2) the politico-economic function of income tax withholding; and (3) the consistency of the U.S. income tax withholding experience with a more general economic model of institutional and ideological change.

A systematic transaction-cost framework for understanding the evolution of withholding will be suggested as a way of integrating this critical episode with other U.S. policy experiences. Historical circumstances facilitating adoption and expansion of income tax withholding

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will be seen to reflect broader incentives of government officials to alter political transaction costs facing the public. Equally important, the willful alteration of political transaction costs will be viewed as supporting institutional and ideological changes that, over time, expand the publicly accepted scope of government authority.

Government manipulation of political transaction costs contributed significantly to the institutional changes and subsequent ideological transformation supporting income tax withholding. Though in 1943 the withholding mechanism was sold politically as a benefit to taxpayers, government officeholders even then widely regarded it as a means of extracting greater tax revenue. Senators and representatives spoke candidly in congressional hearings (U.S. Senate Hearings 1943: 43) of the revenues that needed “to be fried out of the taxpayers.”

This article is organized as follows. I first develop a theoretical framework for analysis of federal income tax withholding. After discussing the early evolution of income tax withholding in the United States, I then consider how changing institutional contexts have influenced attempts to expand withholding. The final section of the article ponders the reversibility of current withholding mechanisms in light of the paper’s theory and evidence.

Institutional and Ideological Change: A Theoretical Framework

Many scholars have identified politico-economic patterns associated with taxation. For instance, in his study of taxation in the New Deal, Mark Leff (1984) showed that the rhetoric surrounding tax policy often serves a symbolic function inconsistent with actual tax policy. John Witte (1985) emphasized that across a broad span of income tax history changes in tax law have tended to proceed *incrementally* and therefore to generate *complexity*. Dall Forsythe (1977), studying U.S. tax policy during 1781–1833, suggested that tax policy is shaped by recurrent political patterns, including “normal politics,” “regime politics,” “environmental crises” such as war or depression, and “authority crises” such as the Civil War in which the regime’s ability to govern is challenged. He viewed these patterns as helping to explain why similar policy initiatives sometimes generate quite different political outcomes, arguing (1977: 122), for instance, that

if the elite can successfully establish its definition of a situation as a crisis, it can undertake without direct opposition activities which might otherwise be considered gross violations of regime boundaries.

All of the above-cited conceptualizations of the emergence of tax policy may be subsumed by a broader explanation grounded in the

phenomenon of government manipulation of political transaction costs. As employed here, the phrase "political transaction costs" denotes transaction costs involved in making political decisions on issues that influence the scope of government authority.¹ Those transaction costs include not only costs of obtaining information regarding an authority-influencing issue, but also costs of taking collective action to support one's policy preferences. A transaction-cost-manipulation model identifies the endogeneity of a broad range of transaction costs affecting the accepted scope of government authority, and it endeavors to specify both the circumstances that give rise to government augmentation of political transaction costs and the consequences of that behavior.² I have analyzed theoretical dimensions of this model in greater detail elsewhere (Twight 1983, 1988, 1994). In the present context, I want only to summarize salient features of the model as a backdrop for this article's historical analysis of the evolution of U.S. income tax withholding policy.

Transaction-cost-manipulation theory builds on the idea that government officials, as individuals, have strong incentives to try to alter political transaction costs facing citizens and others in government. If they can raise the transaction costs to voters of opposing a policy that the officeholders (or influential constituents) favor, the officeholders' policy preferences are more likely to prevail. Clearly, if government officials make it harder for most citizens either to perceive an unwanted policy (e.g., a tax or special-interest legislation) or to organize to resist it, public opposition is less likely to materialize. In the presence of transaction-cost augmentation, political resistance to policy initiatives is thus in part a function of government officeholders' volitional choices to raise transaction costs of particular types of collective action, not solely a function of citizens' or other officeholders' preferences.

We will see in the next section that income tax withholding is both an instrument and a result of transaction-cost augmentation. Withholding's transaction-cost-increasing features and implications

¹Alternatively, such political transaction costs could be labeled "constitutional-level" transaction costs (see Twight 1988, 1992) to emphasize their influence upon the nature and extent of government authority over private decisionmaking tolerated by the public. In this broad sense, to conceptualize them as "constitutional-level" implies only that they influence where the line is drawn between the public sector and the private sector; it does not presuppose linkage to or embodiment in a formal constitutional document. Regarding alternative loci of a constitution, see Higgs (1988: 374-75).

²Transaction-cost-manipulation theory thus is concerned with what may be called "contrived" political transaction costs, volitionally created by political actors for their own benefit. The residual political transaction costs that exist when all agents are attempting to minimize transaction-cost barriers to political decisionmaking will be referred to as "natural" transaction costs.

for the growth of government were well captured by David Brinkley (as quoted in Jones 1989: 730), who stated that, with withholding

Congress and the president learned, to their pleasure, what automobile salesmen had learned long before: that installment buyers could be induced to pay more because they looked not at the total debt but only at the monthly payments. And in this case there was, for government, the added psychological advantage that people were paying their taxes with not much resistance because they were paying with money they had never even seen.

As George Lent (1942) described it in the *Journal of Political Economy*, “the taxpayer does not have the same consciousness of parting with his income to the government,” making withholding “the most ‘painless’ method of meeting tax liabilities.” The following section explores the extent to which government decisionmakers not only understood this result *ex ante* but also used other types of transaction-cost manipulation to achieve it when they instituted income tax withholding in 1943.

Since the history of U.S. income tax withholding documented below involves extensive misrepresentation by government officeholders, and since withholding itself alters perceptions of private tax burdens, one may legitimately ask whether a transaction-cost manipulation model is concerned exclusively with use of political deception. As the preceding paragraphs imply, the answer is no. Whether or not deception is involved in passage and implementation of a law such as the Current Tax Payment Act of 1943, the institutions and constituencies thereby fostered can significantly alter the transaction costs of political resistance to present and future government policies. In short, political transaction costs involve costs of individual and collective political action broadly defined, not just information costs. Regardless of the strategies by means of which income tax withholding became law in the United States, the institutional practice of withholding affected in predictable ways the political viability of income taxation and the government policies such taxation supports.

Consider the following conceptual experiment to assess the policy neutrality of income tax withholding. Suppose that we eliminated mandatory withholding for a year and instead required taxpayers to send in checks on April 15 for the full amount of their annual federal income taxes. The likely consequences of this institutional change are consistent with government officials’ beliefs (documented below) concerning the role of withholding in increasing private individuals’ costs of tax resistance. Most relevant here, with government-mandated withholding, such increased costs of tax resistance would exist even under the counterfactual assumption of perfect public understanding

of the impact of withholding on the real burden of taxation: that is, they need not depend on continuing deception.

Transaction-cost augmentation takes myriad forms. On the collective-action side, it includes changing the locus of decisionmaking authority so as to shift the transaction-cost burden entailed in effectuating changes in the role of government,³ changing the cost to private citizens of achieving political agreement to revise the scope of governmental authority, changing the interaction between governmental agencies to alter the cost to individuals of revising the scope of government authority, and concentrating the benefits and dispersing the harm born of government action (Twight 1988: 150, fn. 1 and 2; 1994). On the information-cost side, transaction-cost manipulation includes such strategies as semantic efforts to alter public perceptions of the costs or benefits of government activities, forms of taxation that change people's perception of the actual tax burden imposed upon them, and overt distortion of information about the nature and consequences of government activities.

Many superficially disparate forms of political or legislative behavior fit within this model, and the model helps us to predict the context-specific likelihood of politicians' use of such strategies. Leff's (1984) evidence of symbolic rhetoric as well as Witte's (1985) evidence of the roles of incrementalism and complexity thus may be viewed in this broader context. Moreover, governmental attempts to milk bogus crisis circumstances for expanded authority, as described by Forsythe (1977), involve analogous efforts to raise transaction costs to the voting public of resisting governmentally favored policy measures. In other policy contexts, diverse political strategies—such as inserting riders in omnibus bills, diffusing tax costs of public policies, expanding sovereign immunity doctrines, establishing ballot-access laws that differentially impact third parties, and using federal tax money (such as federal funding for universities and highways) as a lever to foster unrelated federal policies—all alter the transaction costs to private citizens of participating in political processes affecting the role and scope of government.⁴

The question is, under what circumstances is it more likely that government officials will choose to employ transaction-cost augmentation? In previous research (Twight 1988) I have suggested that a

³For example, U.S. Supreme Court redefinition of the Constitution's interstate commerce clause in ways that previously would have required constitutional amendment.

⁴The examples in the text are intended to be suggestive rather than exhaustive. For a more complete discussion of political behaviors and policies that exemplify transaction-cost augmentation, see Twight (1994).

government official's decision to favor a transaction-cost-increasing measure is likely to be a positive function of identifiable variables, including the issue's complexity,⁵ the availability of an appealing (though possibly incorrect) rationale for the measure, executive support and party support for the measure, third-party payoffs, the measure's perceived importance to constituents, and its promise of job security and perquisites for the officeholder. The official's decision is expected to be a negative function of publicity or media attention directed at the measure's transaction-cost-increasing features. The impact of time is an empirical issue because, while it counteracts complexity, it also facilitates entrenchment of beneficiary interest groups. The officeholder's ideology also is expected to play an important role, influencing him to favor measures that raise the transaction costs of opposing measures that the officeholder favors on ideological grounds.⁶

As preliminary evidence of the relevance of a transaction-cost-augmentation model in explaining the development and extension of U.S. income taxation, consider two studies. Although the authors did not analyze their results in these terms, both Carolyn Jones (1989) and Ben Baack and Edward John Ray (1985a, 1985b) provide evidence of the importance of political transaction-cost manipulation in engineering acceptance of the income tax.

Jones documented the widespread and systematic use of propaganda by U.S. government officials during World War II to quell resistance to the transformation of the income tax from a "class tax" to a "mass tax" during those years. This propaganda ranged from pressuring radio broadcasters to air "plugs" promoting income tax payment to providing story lines to magazines. However, in Jones's view (1989: 716) the "crown jewel of tax propaganda" was a Disney

⁵The complexity and appealing rationale variables require further comment. An issue's complexity may be either unavoidable (hence a "natural" transaction cost of understanding an issue) or itself a product of transaction-cost augmentation (hence a "contrived" transaction cost). Similarly, an appealing rationale may be either false (a contrived transaction cost that in turn facilitates other forms of transaction-cost augmentation) or true. In either case, the direction of impact on an officeholder's decision regarding a transaction-cost-increasing measure is as described in the text. Issue complexity, like the existence of an appealing rationale, makes it harder for citizens to perceive transaction-cost-increasing features of policy proposals. Moreover, both of these conditions allow politicians greater room to credibly claim to have made a "mistake" if negative public reaction to the measure's transaction-cost-increasing features does materialize.

⁶These relationships have proved consistent with actual U.S. policymaking experience in such apparently diverse arenas as off-budget expenditure through the Federal Financing Bank, military base closures, asbestos regulation, and U.S. Social Security legislation (see Twright 1983, 1989, 1991, 1993).

film entitled *The New Spirit* commissioned and promoted by the U.S. Treasury Department, in which Donald Duck was informed "that it is 'your privilege, not just your duty, but your privilege to help your government by paying your tax and paying it promptly'." More than 32 million people saw the film in the first few months of 1942, and a Gallup poll reported that "37 percent felt the film had affected their willingness to pay taxes" (Jones 1989: 717). Without doubt, such government propaganda manipulated political information in ways that raised the expected marginal cost of income tax resistance.

Lest Jones's observations appear anomalous, note that the U.S. government employed income tax propaganda well before World War II. During World War I, the secretary of the Treasury explicitly suggested use of "widespread propaganda" to convince the public to forgo their "needless pleasures" (U.S. Treasury Department 1918: 2). The Treasury Department implemented what it called a "campaign of education" regarding the income tax. Its "essential features" included government-supplied news stories and editorials as well as encouragement of special cartoons and films. Perhaps its most intriguing feature, however, was its use of the clergy. The commissioner of Internal Revenue reported that "Thousands of clergymen, *at the suggestion of the Bureau*, made taxation the subject of at least one sermon." As a result of the "patriotic response" aroused, "dissatisfaction and complaint over the burden imposed by taxation were minimized." Government officials commented that "the groundwork was laid for securing in ensuing years prompt and regular response to revenue demands." To perpetuate its success, the Bureau of Internal Revenue advocated "the most intensive cultivation of intelligent public opinion" (U.S. Treasury Department 1919: 964-65, 974; see also Higgs 1987: 133-34).

In the second aforementioned study, Baack and Ray examined an earlier period of tax history to discover why it was that, although the 1894 income-tax statute was declared unconstitutional by the Supreme Court in 1895, a constitutional amendment was not introduced in Congress until 1909. Their results suggested the "pivotal role of federal transfer payments in securing passage of the Sixteenth Amendment in 1913" (Baack and Ray 1985a: 607). Between 1895 and 1909, government officials—acting through the secretary of War, the secretary of the Navy, and the commissioner of pensions—channeled disproportionate government military-related outlays to the states whose congressional delegations up to that time had consistently opposed the income tax. For instance, 74.7 percent of the increases in annual War Department expenditures on army arsenals, posts, and public works between 1897 and 1908 went to the 17 states that previously had

opposed income tax legislation. To Baack and Ray (1985b: 128–31), this and related evidence appeared “consistent with the possibility that naval expenditures and veterans benefits were used to buy state votes to support the income tax amendment.” These targeted outlays and the implicit possibility of their withdrawal clearly raised the opportunity costs to affected legislators and their constituents of continuing to resist the income tax. Deliberate choices by government officials again reshaped political transaction costs influencing the role and scope of government.

Even if one grants the prevalence of political transaction-cost augmentation, still one may ask what difference it makes. Can we not expect the public, in a representative democracy, to reverse political arrangements incompatible with their preferences? Unfortunately, we cannot. Transaction-cost-increasing measures by definition raise the costs to individuals of particular forms of political action. For any given distribution of political opinion, such measures therefore drive a wedge between people’s preferences and the political expression of those preferences. Policies unwanted by the bulk of the citizenry may survive.

Moreover, transaction-cost-increasing measures often alter the institutions of government, changing society’s institutional bedrock. In the long run, such institutional changes tend to reshape predominant societal ideologies so as to validate existing government authority—in effect molding people’s beliefs to conform to the new institutional status quo. In his study of crisis-induced changes in government authority, Higgs (1985, 1987) has shown how institutional change generates self-validating ideological change as people become accustomed to and “learn to like” the new institutional arrangements. Such ideological changes also occur as a result of people’s reticence to express unpopular views in public. As Timur Kuran (1987, 1991, 1993) has shown, given the institutional status quo, people often have strong incentives to misrepresent or “falsify” their preferences in public discourse. As a result, succeeding generations receive less exposure to public discourse questioning the status quo, and more exposure to public discourse affirming it. Accordingly, subsequent generations may perceive many societal decisions embodied in the institutional status quo as settled, despite widespread (though unexpressed) private preferences to the contrary. Over successive generations, institution-validating ideological change is the likely result.

Political transaction-cost manipulation thus matters in a larger sense because it artificially redirects political action, facilitating institutional changes that ultimately distort public discourse and channel ideological change in ways potentially inconsistent with people’s initial prefer-

ences—and, sometimes, preexisting constitutional law. For theoretical reasons explored in greater detail elsewhere, this politico-economic sequence typically eventuates in greater dependence on government (Twight 1993).⁷ The balance of this paper analyzes the extent to which the model is consistent with the establishment and expansion of income tax withholding in the United States.

Early History of Withholding: A Reinterpretation

Wherever an income tax has been in practice for any time the small incomes as well as the large are taxed; and it is the small incomes which yield the largest revenue to the state.

—Treasury official Worthington C. Ford (U.S. Senate 1894)

U.S. Income Tax and Withholding Experience Before 1940

An income tax was first employed in the United States during the Civil War. Although many, including the secretary of the Treasury, desired longer retention of the Civil War income taxes, the taxes were widely viewed as emergency measures and were repealed in 1872. This was a time when even the commissioner of Internal Revenue recommended repeal of the income tax, writing to the chairman of the House Ways and Means Committee that he regarded the income tax as “the one of all others most obnoxious to the genius of our people, being inquisitorial in its nature, and dragging into public view an exposition of the most private pecuniary affairs of the citizen” (U.S. House 1871: 1). Such opinions provide a baseline against which to assess later changes in public sentiment.

Though proposed many times, income tax legislation was not enacted again until 1894. Consistent with a transaction-cost-manipulation model, Congress labeled the 1894 law “An act to *reduce taxation*, to provide revenue for the government, and for other purposes.” When challenged in the case of *Pollock v. Farmers’ Loan and Trust Company*, the income tax law was held unconstitutional by the U.S. Supreme Court because it established a “direct” tax on real property and invested personal property deemed unconstitutional without apportionment among the states according to population as mandated by the Constitution (157 U.S. 429, 158 U.S. 601, 1895).⁸

Income taxes temporarily were stymied. There was strong sentiment in the Senate to pass similar legislation and again confront the Supreme Court on this issue. Wanting to avoid such a confrontation, President Taft in 1909 recommended both a corporate income tax, labeled as

⁷The emergence and entrenchment of Social Security legislation in the United States has proved consistent with this model’s description of the nexus between transaction-cost manipulation, institutional change, and ideological change (see Twight 1993).

an "excise" tax to avoid constitutional censure, and a constitutional amendment authorizing taxation of income from all sources without apportionment among the states (U.S. Senate 1909). Many staunch opponents of income taxation nonetheless supported Taft's proposal, hoping that the corporation income tax and the cumbersome amendment process would erode support for more broadly based income taxation. Congress submitted the proposed Sixteenth Amendment to the states for ratification in 1909.

A confluence of circumstances facilitated adoption of the income tax amendment. Chief among them was widespread belief that the existing federal tax system, with its reliance on tariffs and excise taxes, unfairly burdened the less affluent. Noting "a growing conviction among people from all walks of life that the existing tax system failed to reach the great fortunes that had been amassed as a result of industrialization," John Buenker (1981: 185) identified such beliefs as the "single most important reason for the eventual enactment of the federal income tax." Then as now, people's tax preferences often were driven by beliefs about tax incidence. Detailed studies of the history and politics of the period indicate intense desire on the part of various regional and economic groups to rearrange taxes to make others pay a disproportionately high share of governmental costs (Buenker 1981, Ekirch Jr. 1981). Thus most low-income Southern and Western states endorsed federal taxation based on "ability to pay" and favored a graduated federal income tax differentially burdensome to wealthier states in the North and East. As noted in the preceding section, the apparent manipulation of federal transfer payments also may have contributed to some states' approval of the amendment (Baack and Ray 1985a, 1985b). Widespread concern about cost-of-living increases partially attributed to import tariffs, along with increases in U.S. exports and military expenditures, created additional pressures to find alternative sources of federal revenue. Strengthened by elections in 1910 that reduced Republican representation in many state legislatures, these mutually reinforcing conditions led many states previously opposed to the income tax to favor the amendment.

As the Sixteenth Amendment moved toward ratification, some state governors waxed eloquent in their support of the income tax amend-

⁹The Supreme Court did not comment on the law's taxation of gains from business and employment, citing "the instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax [not subject to apportionment] and been sustained as such" (158 U.S. 635). Later writers and judges interpreted *Pollock* to mean that the validity of such taxation was recognized and that there was "no dispute" about that issue (*Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 17, 1915). For extended discussion of the *Pollock* case, see Higgs (1987: 99-103), and Arthur Ekirch Jr. (1981: 168-71).

ment. Governor John Franklin Fort assured the people of New Jersey that the citizenry can be relied upon “to see that their representatives make no unjust exactions in the way of taxation or in the curtailing of the rights of the States or otherwise,” that the amendment “is vital to the safety and security of the Republic,” and that it “is without danger in the power conferred” (U.S. Senate Doc. No. 365, 1910: 5). Some believed that income taxes authorized by the amendment would be implemented only during emergencies. Presaging later transaction-cost augmentation, Senator Norris Brown (R., Nebraska) asserted that the income tax amendment “lays no tax, promises to lay none, but simply and solely restores to the people a power many times sustained but finally denied by the courts” (U.S. Senate Doc. No. 705, 1910: 6).

The 16th amendment became constitutional law in February 1913. Contrary to Senator Brown’s implication, income tax legislation was adopted in October of that year.

The 1913 statute authorized withholding of income taxes “at the source”—that is, extraction of income taxes from taxpayers’ pay envelopes before salaries were paid. Precedent existed in the income tax withholding for government employees during the Civil War (Bopeley 1943). However, the 1913 law’s withholding provision proved to be a great irritation to taxpayers, a fact downplayed in later discussions of withholding. Based on public criticism, Treasury Secretary William C. McAdoo reported that “it would be very advantageous to . . . do away with the withholding of income tax at the source” because it would “eliminate a great deal of criticism which has been directed against the law” (U.S. Treasury Department 1916: 19). The following year the commissioner of Internal Revenue, in a report also signed by McAdoo, formally recommended that “the provisions of law requiring the withholding of the normal income tax at the source of the income be repealed” (U.S. Treasury Department 1917: 674). The authority for withholding was withdrawn in 1917, not to be resurrected until the 1940s.

The Current Tax Payment Act of 1943

Despite the 1913–16 experience, Congress in 1943 passed the Current Tax Payment Act, establishing the broad-based income tax withholding that has continued to this day. The important politico-economic question is how and why. This section discusses transaction-cost-increasing strategies used to structure political support for a policy previously so unpopular with the public. We will contrast the ostensible and actual purposes of the withholding law, analyzing the political mechanisms that made its passage possible.

Conventional wisdom suggests that withholding became advantageous to the public with the vast expansion of income taxation that occurred during World War II. In fact, the military crisis facilitated establishment of institutional mechanisms that served long-run interests of government and its functionaries rather than the public, with crisis providing an essential ingredient and cover for all manner of misrepresentations used to secure passage of the withholding act. As Higgs (1987), Forsythe (1977), and others have noted, real or purported crisis often provides a *carte blanche* for expansion of government authority. In the more general framework employed here, crisis facilitates transaction-cost augmentation by influencing its determinants—providing an appealing rationale for transaction-cost-increasing measures, stimulating executive and party support for such measures, prompting favorable media coverage, and shortening the public's time horizon so as to focus attention on the emergency at hand and deflect attention from transaction-cost-increasing features of proposed legislation.

We know that World War II prompted transformation of a tax long endorsed by the public as a tax on the rich into a tax on the masses—a “people's tax” in the familiar words of Treasury Secretary Henry Morgenthau Jr. (U.S. Senate Hearings July-August 1942: 3). The numbers have been widely reported elsewhere. A Treasury Department official testified in early 1943 (U.S. House Hearings 1943: 2):

Up until 1941 we never received as many as 8,000,000 individual income-tax returns in a year. In 1941 that number increased to 15,000,000; in 1942 it increased to 16,000,000. This year we expect 35,000,000 taxable individual income-tax returns.

It was one thing to pass the laws that authorized such taxation. The troubling question for government officials was how to assure that the taxes would be paid. Early on, they recognized that income tax withholding could get the job done; the problem was how to sell it to a public previously hostile to such measures.

Ostensible versus Actual Purposes of Withholding. In 1941 Albert G. Hart, professor of economics at Iowa State College, proposed a general plan for collection of income taxes at the source (U.S. House Hearings 1941: 330–48). The next year Treasury Secretary Morgenthau (U.S. House Hearings 1942, vol. 1: 5) recommended income tax withholding, presenting it as a “more convenient method for the payment of income taxes.” Government concern for the well-being of the taxpayer was the dominant theme. Throughout this period the Treasury Department consistently portrayed the withholding proposal as providing taxpayers “a way of meeting their tax obligations with a

maximum of convenience and a minimum of hardship” (U.S. House Hearings 1943: 9). As Treasury official Randolph Paul (U.S. House Hearings 1943: 10) put it:

The tax has been broadened to reach many millions of additional taxpayers with small incomes and little experience in planning their finances to meet large bills at infrequent intervals. . . . A suitable pay-as-you-go method will be of great assistance to millions of persons.

The fact that withholding had been tried before, and that the public had strongly opposed the earlier withholding system, seldom was mentioned.⁹

As the president and Congress imposed ever higher income taxes, tax payment was wrapped in patriotism. In congressional hearings as in government propaganda efforts documented by Jones (1989), sacrifice was a dominant theme. Treasury officials (U.S. House Hearings 1941: 49; Higgs 1987: 202–03) labeled proposed tax increases “light indeed as compared to the sacrifices which large numbers are undergoing in entering military services.”¹⁰ Secretary Morgenthau (U.S. Senate Hearings July-August 1942: 8) urged Congress to adopt a “courageous tax bill,” avowing that “acceptance of sacrifice on the home front is a yardstick of our determination to win the war.”

Although taxpayer convenience and patriotic sacrifice were the avowed purposes of income tax withholding, the actual objectives—though not trumpeted to the public—were candidly acknowledged in congressional hearings. These harsher objectives included increasing government revenue, enforcing payment of taxes, and muting taxpayer resistance. Treasury officials viewed pay-as-you-go withholding as a way to “collect some money from people who would not otherwise make any report on income,” testifying that “We cannot get those fellows unless we have the collection-at-the-source method” (U.S. Senate Hearings July-August 1942: 137). They advocated “us[ing] the tax system as we would a delicate surgical tool” (Paul 1943: 327). A recurrent theme was “the far greater collectibility of the tax if it is collected currently” (U.S. House Hearings 1943: 76).

Fear of taxpayer resistance was prevalent. One witness (U.S. House Hearings 1943: 391) warned that, without withholding, “taxpayers will simply throw up their hands and in a defiant tone say, ‘Try and collect.’” That fear surfaced again in an exchange (U.S. Senate Subcomm. Hearings, August 19, 1942: 61) regarding withholding between Senator Bennett Champ Clark (D., Missouri) and Treasury’s Randolph Paul:

⁹I found only four brief references to it in thousands of pages of hearings.

¹⁰On the widespread use of this rationale during World War II, see Higgs (1987).

Senator Clark: Psychology almost certainly ought to be considered in the tax year. Some British Chancellor of the Exchequer once said: "Taxation consists of getting the greatest amount of money with the least amount of squawks."

Mr. Paul: Do you think if we cut down the squawking under this method we could raise the individual tax rates?

Senator Clark: That is what I am trying to find out: How we can raise the greatest amount of money with the least amount of hardship on the taxpayer.

As transaction-cost-augmentation theory suggests, "squawking"—vocal resistance to taxation—was viewed as manipulable, controllable by officeholders' deliberate decisions to change institutional mechanisms of government.

Long-term advantages of withholding to the government were apparent to Congress. As Representative Donald H. McLean (R., N.J.) put it (U.S. House Hearings 1943: 85), the advantages involved "protecting the Government revenues not only now, but for all times to come." McLean believed that everyone felt "the need for the change in the collection method, due to the increase of the number and type of taxpayers that we have brought into the system." Witnesses testified (U.S. House Hearings 1943: 187) that it would be "good business" for the government: government "will have more revenue; . . . its people will pay better and be happier about it."

Nonetheless, an effort was made to maintain a facade of solicitous concern for the taxpayer. Whenever a crack appeared in the facade it was quickly smoothed over—as when a Treasury official discussing withholding (U.S. House Hearings 1943: 32–33) referred to the "person *against whom* the method was applied" and quickly corrected himself to say "or I might say in whose *favor* it was applied."

Political Strategies for Effectuating Withholding. The key strategies used to obtain support for income tax withholding in 1943 all entailed political transaction-cost augmentation. Government officials artfully employed national defense language, tax-cost information, and promises of "tax forgiveness" to engineer support for a withholding system at root designed to enhance and protect government revenue for all times to come. The above-noted conflict between the government's actual objectives and its publicly promoted objectives formed only one part of a systematic pattern of transaction-cost manipulation documented below.

Disingenuous use of the defense theme to secure tax increases was acknowledged in congressional hearings. Representative Frank Carlson (R., Kans.), admonishing witnesses to use such language, reminded them that the House Ways and Means Committee "passed

a 10-percent increase in our income and corporate taxes a year ago by calling it a *defense tax*." He opined (U.S. House Hearings 1942, vol. 1: 508) that "the suggestion that we call this tax a war tax is a good one." The power of the war image to overcome political resistance also was evident in polling data to be discussed below. Similarly, in discussing the issue of "forced savings," Representative A. Willis Robertson (D., Va.) noted that the "word 'forced' is not a euphonious name" and that it "would be much better if we should call it 'Victory savings,' or something of that kind" (U.S. House Hearings 1942, vol. 1: 108). Treasury official Randolph Paul agreed. The language enwrapping revenue legislation was not lightly chosen.

Other forms of political transaction-cost manipulation also proved instrumental in securing passage of income tax withholding legislation. Those strategies were evident in government officials' handling of (1) the present-value issue, (2) the Ruml plan, and (3) the final debates.

1. Present-value issues were pivotal to important misrepresentations surrounding income tax withholding proposals in the early 1940s. In the 1920s and 1930s, income taxes had been due and payable on March 15 following the end of the tax year—for example, 1938 taxes were due on March 15, 1939, and could be paid either in one lump sum on that date or in quarterly installments during 1939. The proposed system would require employers to extract tax payments out of each paycheck during the tax year, so that a given year's taxes would be paid largely during that same year.

Treasury officials repeatedly testified to Congress that such withholding of income taxes—current collection at the source—represented "no additional tax." On dozens of occasions, Treasury official Randolph Paul and other government spokesmen testified:

This collection at the source mechanism is nothing but a mechanism for collection. It is not an additional tax. . . . It merely speeds up the collection (U.S. House Hearings 1942, vol. 1: 100).

It should be kept in mind that collection at the source does not in itself increase or decrease the tax liability of the taxpayer (U.S. House Hearings 1943: 11).

Given the expert witnesses' knowledge of present value, statements so seriously misleading to Congress and the public could not have been inadvertent.

Treasury officials and members of Congress who repeated these statements implicitly treated dollars today as identical in value to future dollars. This indefensible foundation of the Treasury's analysis was not made clear to Congress or the public. Indeed, in his congressional testimony, Randolph Paul simply added up an individual's tax

liabilities over various years, without making a present-value computation, to compare that person's total tax burden under various proposals (U.S. House Hearings 1943: 23 ff.). When members of Congress probed too closely, Paul and other officials usually sidestepped their questions.

Nonetheless, some astonishing statements were elicited. Consider the 1942–43 House hearings on this issue. When Representative Thomas A. Jenkins (R., Ohio) protested, "I have seen taxes collected after they have accrued, but I never saw them collected 6 months ahead of time," Treasury Secretary Morgenthau replied, "You are putting it very bluntly, but that is what we are proposing to do." The Treasury Department repeatedly acknowledged that this represented "payment in advance" (U.S. House Hearings 1942, vol. 1: 22, 57, 78). Yet Treasury officials insisted (U.S. House Hearings 1943: 36):

There is nothing in collection at the source that imposes any additional tax burden. Collection at the source relates entirely to the method and time of payment. It advances payment which otherwise would not be made until the following year, under our present system, to the current year—indeed, to the very time when the payment to the salary recipient is made.

Whether or not members of Congress understood the concept of present value, it is clear that Treasury officials did. Milton Friedman, then working for the Treasury Department, certainly was cognizant of present values when he stated (U.S. Senate Subcomm. Hearings, 19 August 1942: 58) to a congressional subcommittee evaluating alternative tax plans, "You must also take into account the timing of the receipts." Randolph Paul alluded to the government's "power to make up the loss [associated with eliminating certain tax liabilities] by *compelling quicker collections*" (U.S. House Hearings 1943: 17). Treasury officials further demonstrated their understanding of the time-value of money by recommending that the Bureau of Internal Revenue be required to pay interest on amounts refunded under the new tax law (U.S. Senate Hearings 1943: 35).

Moreover, before withholding was reestablished in 1943, the government sold interest-bearing "tax anticipation notes" which private citizens could buy during the year to generate interest to help pay their taxes when they were due the following year (see *U.S. Cong. Rec.-Senate* 14 May 1943: 4419). Like other investment vehicles, such tax anticipation notes enabled taxpayers to set aside a smaller amount in the present to satisfy any given future tax liability. In contrast, under the proposed withholding system—with identical tax rates—the taxpayer would have to forgo a larger sum in present-value terms to satisfy the tax collector. The government, not the taxpayer, would

receive the benefits obtainable from earlier command over that income.

Nonetheless, the Treasury Department's claim that withholding was not an additional tax was repeated by members of Congress on the House and Senate floor and elsewhere. On this fundamental issue, government officials systematically raised the transaction costs to the public of assessing the proposals at hand. Accordingly, while other features of the bill prompted bitter dispute, by the time the Current Tax Payment Act reached the floor of Congress there was no dispute about current withholding of income taxes at the source. Ironically, transaction-cost augmentation was employed to curry support for a proposal that, once adopted, in turn would serve as a key mechanism for increasing other political transaction costs facing the public.

2. Transaction-cost augmentation also took other forms, including a "paper forgiveness" of income taxes that came to be known as the Ruml plan. As Congress considered various withholding proposals, a key transitional problem became apparent. Immediate conversion to a pay-as-you-go system seemed to entail double taxation in the transition year. That is, if a pay-as-you-go system were adopted in 1943, during 1943 people would be required to pay both their 1942 taxes (under the old law) and their 1943 taxes (via the new withholding arrangement). Although Treasury officials thought that was a fine idea, most others disagreed.

Accordingly, various proposals aimed to soften this effect. The Treasury was willing to spread out the extra year's tax over an extended period to accomplish the transition. However, the idea that captured the public's attention was Beardsley Ruml's proposal (first made in the summer of 1942) to cancel or "forgive" one year's tax, treating amounts paid or withheld in 1943 as payments toward a person's 1943 tax and eliminating 1942 tax liability.¹¹ Using the metaphor of daylight savings time, Ruml proposed to set the "tax clock" ahead one year.

Two things stand out from the convoluted history of Ruml's proposal. The first is that it was absolutely critical to—and perhaps the proximate cause of—public acceptance of income tax withholding in 1943. The second is that the tax "cancellation" involved was a sham and was understood to be a sham by a significant number of government officials involved in its passage. Both of these conclusions point to the transaction-cost-increasing role of the Ruml plan in securing passage of the Current Tax Payment Act of 1943. Sham or not, taxpayers liked the sound of the words, and government officials were

¹¹Beardsley Ruml, of R. H. Macy & Co., was at the time chairman of the Federal Reserve Bank of New York.

attentive to the nuances. The psychology of taxation was a recurrent theme. As Ruml testified, "there is a power in words to evoke emotion, and double taxation evokes emotion." He explained (U.S. Senate Subcomm. Hearings 19 August 1942: 5) that "People don't believe in double taxation, even though the single taxation may be the sum of the two." The Current Tax Payment Act played on this psychology.

The polling data support the supposition of Representative Robert L. Doughton (D., N.Car.) that "one of the principal reasons for the popularity of this plan [is] the fact that it relieves the taxpayers of the year's taxes."¹² Although pay-as-you-go income tax withholding had been under discussion in Congress since 1941, by June 1942 public sentiment remained quite equally divided on the idea. For example, asked in May and June 1942 if they would "like to have a regular amount deducted from each pay check" to pay their federal income tax, 43 percent of the respondents said no, 50 percent said yes, and 7 percent were undecided. In a similar poll conducted on February 3, 1942, 45 percent said no, 45 percent said yes, and 10 percent were undecided (Gallup 1972: 338; Cantril 1951: 324). It was not a groundswell. The only polls during this pre-Ruml-plan period that found substantial support for withholding were those that inserted the phrase "to help the war effort" in their question.¹³

However, after the Ruml plan was introduced in July-August 1942 and the idea of tax cancellation or forgiveness was touted in the popular press, there was a dramatic change in public sentiment. Polls conducted November 1942 to April 1943 found that a steadily rising percentage of respondents favored pay-as-you-go withholding, with support for the proposal ranging from 65 percent to 79 percent without mentioning war in the question. A similarly large percentage of respondents reported familiarity with the Ruml plan. Of the 81 percent of respondents who had heard of the Ruml plan in January 1943, 90 percent of those who expressed an opinion about it favored the plan. In February 1943, 42 percent of respondents expressed their belief that the Ruml plan would mean that they would not have to pay tax on their 1942 incomes (Cantril 1951: 324-25; Gallup 1972: 366, 371).

Thus it appears that the public jumped at the bait of tax forgiveness. The issue is whether the hoped-for cancellation was real. On the most obvious level, collecting two years' taxes in one year in the process

¹²U.S. House Hearings 1943: 184. Chairman Doughton incorporated this phrasing in a rhetorical question.

¹³Two poll questions in May 1942 that described withholding as an idea "to help the war effort" found 64 percent and 72 percent of respondents supported the idea (Cantril 1951: 324).

of moving to a current collection basis would seem to imply greater tax revenues for the government, suggesting that cancellation of 1942's tax would reduce tax revenues. Therefore, one question is whether the government's revenue actually was expected to fall if a comparison was made between double taxation and tax forgiveness in the transition year (i.e., a comparison of current collection at the source with and without tax forgiveness). But that is not the only comparison to be made. Taxpayers naturally are concerned with how they will fare under the existing system versus a proposed new system. Thus another critical comparison is the government's revenue "take" without withholding (the old law), and the government's take with tax forgiveness coupled with current collection at the source (a Ruml-like new law).

Despite their opposition to tax cancellation, Treasury officials did not expect tax revenues to fall viewed from either of these perspectives. Faced with rising popular support of a Ruml-type plan, they repeatedly acknowledged that the post-cancellation situation could be expected to entail a greater tax-take for the government—whether compared with the old law or with a hypothetical situation involving two years' taxes in one. For instance, Randolph Paul testified regarding tax cancellation:

The Government by forgiving a year's tax liabilities would be discarding assets. . . . The Government differs from the business in that it has the power to make up the loss by compelling quicker collections and by imposing additional taxes on the same or other people . . . the cash receipts of the Treasury could be maintained even though the tax liability was forgiven (U.S. House Hearings 1943: 17).

Moreover, Paul acknowledged that, in the expected environment of rising incomes, the government's tax-take would increase under a Ruml-type plan compared with its revenues under the old law, even if tax rates were not raised. With present-value issues just beneath the surface, Paul testified (U.S. House Hearings 1943: 18):

Each individual subject to taxation in 1942 has 1 year's liability canceled, but he is at the same time required to pay another year's liability sooner than he otherwise would. Individuals who were not taxpayers in 1942, but who become taxpayers subsequently, will be obliged to pay their liabilities 1 year sooner than under existing law. Individuals who die, or who cease receiving an income, pay the Government 1 year's less taxes, but by and large the money loss on their account is offset by the gain from new taxpayers who begin paying their taxes a year earlier. . . . The payments dropped out will be spread over a period of years. If any given year is a year of higher national income . . . the actual receipts of the Government for that span of years would be increased by the change.

Former Treasury Department official Elisha Friedman openly called it a “paper forgiveness.” Referring to lower-income taxpayers as “little people,” he stated (U.S. House Hearings 1943: 503) that he “would agree to 100 percent forgiveness for little people, because, frankly, it is a paper forgiveness.” Noting that withholding at the source “makes possible higher tax rates than under the present method,” he testified (U.S. House Hearings 1943: 491, 492, 503):

The ‘forgiveness’ of the small brackets is merely temporary. . . . They will pay more later. . . . You will forgive the 1942 tax for the little people but in 1944 and 1945 they will be paying at a higher rate. . . . Ours is a paper forgiveness for the low brackets.

Some in Congress resisted the language of tax cancellation. Condemning “legislative legerdemain in the cancellation of 1942 income tax liabilities,” Senator Robert M. LaFollette Jr. (R./Progressive, Wisc.) expressed his belief that, in the context of rising war expenditures, the “average taxpayer would rather learn the bad news now . . . than be misled by the false sound of cancellation” (U.S. Senate Report No. 221, 1943, part 2: 1). As Senator Henry Cabot Lodge Jr. (R., Mass.) put it to a Treasury witness (U.S. Senate Hearings 1943: 94), “if you go at it from the standpoint that you live by, that you feed your children on, those things, there is no cancellation at all, is there?”

3. In examining the final congressional debates on this bill, it is not my intention to chronicle either the procedural maneuvers or the detailed differences between contending bills as income tax withholding legislation moved toward passage. Excellent summaries already exist (U.S. Senate 1946). My focus is on central politico-economic strategies that facilitated passage of such legislation.

The conference bill ultimately passed by the House and Senate involved compromise on everything except the fundamental idea of withholding at the source. As Randolph Paul had stated (U.S. Senate Hearings 1943: 2), the three leading bills “reflect[ed] essential agreement on the major issue of current payment.” On the Senate floor, Senator Arthur H. Vandenberg (R., Mich.) reiterated (*U.S. Cong. Rec.-Senate* 2 June 1943: 5209) that “No one questioned at any turn of the road the desirability and necessity of having collection at the source and making the Nation current with its taxes.”

The only disagreement concerned the degree of tax cancellation for 1942. President Roosevelt, having called for a \$16 billion tax increase, stated in writing to the chairman of the House Ways and Means Committee and the Senate Finance Committee that he would veto legislation authorizing 100 percent cancellation of 1942 tax liability. Another constraint was concern that the rich would benefit more

than the poor from tax cancellation. In particular, many wanted to avoid abating taxes on the "windfall profits" of war contractors.

With certain qualifications and exceptions, the bill finally passed authorized 75 percent cancellation of one year's tax liability. Two windfall profit provisions were included in the conference committee bill. In general, the final bill required payment of the higher of one's 1942 and 1943 tax liability. If someone died in 1943, or had much lower income in 1943 than in 1942, that person would not thereby avoid his 1942 tax liability. Moreover, to prevent recipients of "war profits" from receiving a boon, the bill set an additional cap on tax forgiveness for those whose lowest income in 1942-43 exceeded their income in a selected base year (1937, 1938, 1939, or 1940) by more than \$20,000 (U.S. Senate 1946).

Widespread awareness of the transaction-cost-increasing features of the Current Tax Payment Act was evident in the final debates. Despite allusions to alleged mutuality of interest, it was widely understood that income tax withholding was chiefly in the interest of the government, not the taxpayer. Calling current collection "the crux of the whole matter," Senator William W. Barbour (R., N.J.) told the Senate (*U.S. Cong. Rec.-Senate* 12 May 1943: 4271) that "the best interests of the Government will be served if the new tax law requires that taxes be paid while the taxpayer has the money to pay them." Senator Harry Flood Byrd (D., Va.) said (*U.S. Cong. Rec.-Senate* 13 May 1943: 4336) that it was "of great interest and importance to the Treasury, as well as the Government as a whole, that taxes be placed on a pay-as-you-earn basis." Senator David I. Walsh (D., Mass.) added that withholding "is of more benefit to the Treasurer than to anyone else" and "means that the Treasury will be able to collect future taxes" (*U.S. Cong. Rec.-Senate* 2 June 1943: 5210).

Similarly, there was no doubt in the minds of many representatives that the result of withholding, even with tax forgiveness, would be an increase in the tax burden on the public. Although Senator Walter F. George (D., Ga.) as chairman of the Finance Committee repeated the official line that the withholding bill "does not deal with rates directly, nor does it affect the burden imposed under varying rates upon the taxpayers," others were more candid. Senator Barbour noted that "the change in the method of tax collection will unquestionably increase the flow of revenue to the Treasury." Reinforcing this point, Senator John A. Danaher (R., Conn.) observed (*U.S. Cong. Rec.-Senate* 12 May 1943: 4268, 4272, 4282) that "The fact of the matter is the Treasury collections will go up annually rather than down." Senator Byrd predicted that "before the ink is dry on the signatures" establishing a Ruml-type bill as law, the Treasury "will call upon

the Congress to increase the existing tax rates in proportion to the cancelation [*sic*] and forgiveness we extend to the taxpayers." He believed that "so-called benefits to the taxpayer" would then "quickly sink into complete oblivion" so that "most taxpayers would be injured rather than benefited" (*U.S. Cong. Rec.-Senate* 13 May 1943: 4337). Advocates of a Ruml-type plan openly boasted (*U.S. Cong. Rec.-House* 3 May 1943: 3841) that it "would actually bring in \$3,000,000,000 more revenue to the Treasury this year than would the present law."

The fact that tax forgiveness was both a sham and an essential ingredient of public support for the income tax withholding bill was widely discussed in the final debates. Senator Tom Connally (D., Texas), an opponent of the Ruml plan who believed it portended a loss to the Treasury, asserted that the bill "is really intended to fool people." He believed that the Ruml plan would be "blown out of the water" by those "whooping up the Ruml plan" if they became convinced that they were "not going to get any money back" (*U.S. Cong. Rec.-Senate* 14 May 1943: 4408). Senator Clark of Missouri stated (*U.S. Cong. Rec.-Senate* 12 May 1943: 4275) that he "never believed that there was any forgiveness or any personal advantage to anybody in the [proposed] system," perceiving "great governmental advantage in having everyone current with his taxes" and enabling government to "collect the taxes as the taxpayer earns them."

Nonetheless, while some congressmen understood the issue, others succumbed to its apparent complexity. Complexity here facilitated the adoption of transaction-cost-increasing measures, allowing the "experts" to steer the outcome to suit their own interests. Senator Connally of Texas stated that he did "not think there is anyone on the [Senate Finance] committee who completely understands all the angles," noting that taxation had become so complex that the Finance Committee "could never make any progress or headway if it did not have available the experts of the Treasury." He described (*U.S. Cong. Rec.-Senate* 14 May 1943: 4409) the relation between the committee and the Treasury experts as follows:

When a question arises we call on them for information as to what the effect of certain proposals would be, what the repercussions would be, what the reactions would be, and we are obliged to act on the basis of the information thus furnished.

Consistent with transaction-cost-augmentation theory, complexity not only encouraged reliance on experts but also provided political cover for those who took their advice.

Crisis also facilitated passage of income tax withholding legislation. In the dispute over forgiveness or cancellation of 1942 taxes, outraged

opponents of any cancellation impugned the patriotism of their adversaries and asked how one could in good conscience cancel taxes when U.S. soldiers were dying in battle. Countless allusions to “our men and boys . . . dying to win victory and save our country” peppered the debates. Compounding the difficulty of understanding the actual import of the Ruml plan, those convinced that it signified reduction in government revenues invoked the “price in life and limb” being paid on the battlefield, stating that “no sacrifice however great of the citizen taxpayer at home can compare with the privations of the soldier in the field” (*U.S. Cong. Rec.-House* 4 May 1943: 3923, 3928). War and the oft-expressed desire to limit inflation by absorbing citizens’ spending power provided appealing rationales conducive to approval of the income tax withholding measure.

Thus the Current Tax Payment Act of 1943 became law, both product and instrument of transaction-cost augmentation. Though the Act was widely supported by the citizenry, we have seen that wartime public support rested on misunderstandings actively encouraged by government officials. However, the Current Tax Payment Act of 1943 did not arise in an institutional vacuum, nor did its support erode as the public learned more about its effects. That deception was only one part of the fabric of transaction-cost augmentation surrounding this issue is shown below as we consider the interplay between transaction-cost manipulation, institutions, and ideology in shaping the evolution of U.S. income tax withholding.

Changing Institutional and Ideological Contexts: The Role of the Status Quo

Taxes which are easy to collect tend to be extended and expanded with similar ease by legislative bodies. The withholding provisions make it easy for the Treasury to collect taxes from wage earners and low-income groups. We must be ever vigilant to prevent this ease of collection from being used as a lever further to lower personal income tax exemptions or otherwise to impose new burdens on low-income groups.

—National Lawyers Guild
(U.S. House Hearings 1942, vol. 2: 2302)

The institutional and ideological status quo provides context for, and sets constraints upon, further changes in institutions and ideologies. Politico-economic developments are path-dependent.¹⁴ In light of the preceding section’s evidence of government officials’ use of transac-

¹⁴See Higgs (1985: 2–3 ff.; 1987: 57–74).

tion-cost augmentation in effecting adoption of the Current Tax Payment Act of 1943, this section examines the broader institutional context that shaped this result and the long-run institutional and ideological changes that followed it.

The theory discussed earlier in this article predicted that, when institutional change occurs as a result of transaction-cost augmentation, the long-run outcome is likely to be further authority-legitimizing institutional and ideological change.¹⁵ In the case of U.S. income tax withholding, key evidence is to be found in the institutional structures out of which it arose and into which it developed. We will see below that government officials themselves viewed the relevant institutional changes as parts of an incremental process, working to strengthen the "machinery of taxation" over time.

*Institutional Precursors of the 1943 Act:
Building a "Tax Machine"*

Against the backdrop of the failed experiment with income tax withholding during the 1913–16 period, two institutional changes had occurred that significantly influenced the political viability of the 1943 legislation. First, the Social Security Act was adopted in 1935. While extensive manipulation of political transaction costs characterized adoption and expansion of that law (Twight 1993), most important here is that the social security law was funded by means of a payroll tax withheld at the source (Leff 1983). This funding mechanism emerged in the context of a law widely but falsely promoted as giving each "contributor" an "account" in Washington, D.C., that would provide income security in his old age.

Second, in 1942 Congress and the president established a so-called "Victory Tax" over and above other income taxes. Congressional attention to euphonious labeling carried the day. This Victory Tax differed from other income taxes in that it entailed a flat-rate tax of 5 percent above a \$624 exemption and was required to be withheld at the source by employers.

These two taxes undergirded the 1943 withholding law. Members of Congress and witnesses in congressional hearings repeatedly called attention to the linkage. At the outset, in proposing broad-based withholding (U.S. House Hearings 1941: 345), Professor Albert G. Hart reminded key congressional committees:

We are already collecting taxes, or 'contributions' if you like, from a large part of our wage earners and salaried people under the Social Security Act. That offers a nucleus for this reorganization.

¹⁵See notes 1–7, *supra*, and accompanying text.

Besides this, we have already a system of reporting at the source by employers, a force of internal revenue field agents, and so forth. Accordingly, *we have the makings of an adequate tax machine*. Most of the parts are there.

Treasury official Randolph Paul testified (U.S. House Hearings 1943: 12, 78) that the “essential machinery” for collection at the source already was established under the Victory Tax, and that the “social security tax has provided a basis of experience on which we have had to draw.” Treasury Secretary Morgenthau (U.S. Treasury Dept. 1944: 108) described the Victory tax as “a proving ground for the withholding principle.” A Senate report (U.S. Senate Report No. 221, 1943 part 2: 17) noted that the methods of collection mandated by the proposed legislation “have been coordinated generally with those applicable to the Social Security tax . . . to facilitate the work of both the Government and the employer.” The conference committee report on the 1943 bill described it as a change “to a system of collection, payment, and administration based upon the principles underlying the collection of the social-security tax on wages” (U.S. House Report No. 510, 1943: 41).

Experience with the earlier laws was crucial. Stephen E. Rice, employed by the Senate’s Office of the Legislative Counsel, testified (U.S. Senate Hearings July-August 1942: 136) that “All of the employers have had 7 years’ experience” with the Social Security Act, and “they will be in a much better position to do this job than they were to do the social security job back in 1936 when it first went into effect.”

But it was not just experience-induced ease of administration that encouraged policymakers in 1943; it was also expected diminution of public resistance born of institutional familiarity. When Representative Donald H. McLean (R., N.J.) inquired “why the compulsory payment at the source features of the 1913 act were abandoned,” Treasury official Paul’s response (U.S. House Hearings 1943: 82) captured the resistance-eroding effect of an institutional foot in the door:

At that time taxes collected under an income tax system was [*sic*] something new in this country and I think it is fair to say there was some resistance to collecting at the source. . . . We were not used to being income tax payers, but now we have gone along for a period of about 30 years under the income tax system and I think the analogy is far from being very relevant.

Precisely so. Institutional change born of transaction-cost augmentation reshaped government authority in ways that, over time, engendered institution-legitimizing changes in society’s dominant ideologies and heightened receptivity to further authority-expanding institutional change. The institutional status quo in 1942–43—including social

security and “victory” withholding taxes themselves put in place through transaction-cost augmentation—set the stage for the further increment in government authority represented by the Current Tax Payment Act.

Given this sequence, the appeal of incremental change is clear to those who wish to alter fundamental institutions and ideologies in a society. As the history of U.S. social security legislation and tax policy demonstrates, incrementalism increases transaction costs of opposing institutional change due to the lower perceived marginal benefits associated with resisting piecemeal changes. What is remarkable is not that policymakers understand this but that they talk about it—at least when they are no longer in office. Elisha Friedman, an economic consultant formerly employed by the Treasury Department who was greeted by Treasury officials as a “long-lost brother,” was candid. Describing how to extract the maximum out of people’s pay envelopes (U.S. House Hearings 1943: 491, 500, 505), he spoke admiringly of Fraser Elliott, the Canadian Commissioner of Taxation:

[Elliott] made it plain that an essential principle in taxation is ‘Don’t do anything suddenly.’ . . . He said ‘We must follow a policy of doing things so gradually that it is politically acceptable to the voters.’ . . . You have got to get the people’s minds accustomed to things. You have got to work out the political angle, and you have got to work out the administration. You cannot do it suddenly.

Elisha Friedman (U.S. House Hearings 1943: 505) recommended “continu[ing] the tax fantasy a little bit” in order to maximize extraction of resources, explaining that “If you were trying to cure a man of the drink habit, you wouldn’t cut off his supply of liquor all at once. You would do it gradually.” In this ex-Treasury official’s view, retaining one’s own income was analogous to abusing alcohol.

From 1935 to 1942, ideological change also proceeded apace, shaped in part by current generations’ institutional experiences of the accepted role of government. People increasingly grew accustomed to a more expansive role of government through income taxation, social security, and other governmental programs, despite the political transaction-cost manipulation that spawned those programs. Set against ideologies of earlier times when even a commissioner of Internal Revenue had regarded the income tax as “inquisitorial” and “obnoxious to the genius of our people,” the 1943 hearings provided a foretaste of changes already in process. To be sure, many still expressed principled opposition to the income tax. But one can find little in earlier hearings that compares with the following 1943 exchange (U.S. House Hearings 1943: 506) between Representative McLean and ex-Treasury official Elisha Friedman:

Mr. McLean: Do you think there is anything inherently wrong in going too far in compulsory deductions from wages?

Mr. Friedman: I can only come back to this, we have got to do it gradually.

Mr. McLean: Whether you do it gradually or rapidly, I am asking you whether there is anything inherently wrong in taking money out of a fellow's pay envelope without giving him the right to say you are privileged to do it.

Mr. Friedman: Is it wrong for a democratic form of government to do anything? You are the people's elected Representatives. When you decide to do something, it means the people have decided it. *What do you mean, wrong?*

This terse question—and the volumes it spoke about emergent ideological change in the United States—was a harbinger of things to come. Reflecting on the implications of Elisha Friedman's remarks for the American people, McLean (U.S. House Hearings 1943: 506) remarked, "You are trying to take their independence from them."

The pattern of these early events is consistent with the theory under discussion. On one level, the 1943 Current Tax Payment Act was an outgrowth of its institutional predecessors. The political transaction-cost augmentation accompanying adoption of the 16th amendment, tax propaganda during World War I, and implementation of the Social Security Act and Victory tax changed the institutional status quo in ways that reduced resistance to subsequent authority-expanding programs. These early changes increased the government's authority and, with it, its ability to manipulate political transaction costs to further favored policy outcomes such as the 1943 act. Through mechanisms of transaction-cost augmentation, political resistance to these and later measures became increasingly an endogenous product of government officials' institution-modifying choices. Accommodative ideological change ensued.

Later Attempts to Expand Withholding

Similar mechanisms were again evident following 1943's establishment of broad-based income tax withholding. Information reporting on interest and dividend income was established in 1962 (Doernberg 1982). In the late 1970s and early 1980s, efforts were made to expand the withholding system to cover independent contractors' incomes as well as interest and dividend income.

In several dimensions, government officials' later testimony reflected reduced perceived need to conceal their objectives. They wanted tax compliance and said so. Treasury Secretary G. William Miller testified regarding President Carter's proposal to withhold taxes

on interest and dividends (U.S. House Hearings 1980: 5) that “the primary purpose of this particular proposal is to improve compliance and to do so on a basis that is practical and economical.” Donald C. Lubick, Assistant Treasury Secretary for tax policy, was blunt about it, stating (U.S. House Hearings 1979: 79; U.S. Senate Hearing 1979: 88) that, while “withholding results in high rates of compliance,” without withholding “approximately 47 percent of all workers who are treated by payors as independent contractors do not report any of their compensation.” IRS Commissioner Jerome Kurtz (U.S. House Hearings 1979: 97) reported that the data “exhibit the basic trend that reporting compliance is highest for income subject to withholding (wages and salaries), somewhat less for income subject to information reporting, and least for income that is generally subject to neither.”

Although Treasury officials occasionally reiterated their intention to benefit the taxpayer, such rhetoric was not at the core of the government’s argument as it had been in 1943. Compliance was now avowedly the central issue. Brief allusions to taxpayer benefits typically were followed by discussions of compliance. For instance, after proclaiming à la 1943 that “We are proposing no increase in tax, no new tax, no change in taxes . . . merely a change in the method by which individuals will pay the taxes they already owe on their interest and dividends,” Treasury Secretary Miller immediately returned to the compliance issue, stating (U.S. House Hearings 1980: 5–6):

In that area [wages and salaries], where we do have withholding, there is only about a 2- or 3-percent rate of underreporting, while the studies indicate that for interest and dividends from 9 to 16 percent of the taxable income is not reported. This means at least 300 percent greater noncompliance in the [*sic*] areas than in the case of wages and salaries.

Perhaps partly because interest and dividend income was targeted, the present-value issue was more clearly understood by Congress this time around. Time had worked to dispel some of the apparent complexities of the issue. As members of Congress probed, Treasury officials sometimes did not deny that taking people’s money sooner hurt them, and instead tried to argue that not much money was at stake for the individual taxpayer. Treasury Secretary Miller, questioned about the withholding proposal’s tendency to discourage savings, stated (U.S. House Hearings 1980: 12) that the taxpayer “would *only* lose interest on the amount of the tax that would not have been paid as early in the year if there were no withholding.”

His contention that this loss to the taxpayer was negligible again revealed government officials’ inclination to misrepresent policy-relevant facts to the public. Miller’s strategy was to describe the lost

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interest income as a small percentage of the overall asset value, thereby obscuring the magnitude of the taxpayer's actual dollar loss. He stated (U.S. House Hearings 1980: 12-13):

Since the withheld tax on interest paid on a typical savings account averages less than one percent of asset value over the course of the year, at worst the 'loss' of interest on the withheld tax would be less than one-tenth of one percent of asset value.

Supposing an 8 percent annual return on a \$1 million investment, if the withholding rate were 10 percent of earnings, \$8,000 would be withheld from the taxpayer's \$80,000 annual earnings on this investment. Secretary Miller's views notwithstanding, an individual's foregone interest on such withholding would not be negligible; in the aggregate such foregone earnings would be substantial. Astonishingly, in a subsequent response to Representative Richard M. Duncan's (D., Missouri) written questions, Secretary Miller and IRS Commissioner Kurtz (U.S. House Hearings 1980: 34) stated for the record that "For taxpayers who now report the full amount of their taxable interest and dividend income, *there will be no effective change in either their tax liability or the rate of return on their savings.*"

Further attesting to expansion of the transaction-cost-increasing power of government as its authority grows, the 1979 hearing record reproduced a significant excerpt from the Internal Revenue Manual. Under the heading of "Attitude and Conduct of Taxpayer," IRS agents were instructed as follows:

The file may also contain information received through other channels, such as informant's communications, newspaper items, reports from financial institutions regarding unusual currency transactions, 1099's, revenue agent's information reports, reports from other government or enforcement agencies. . . . Information of this type is of a highly confidential nature. *The agent is cautioned not to reveal to the taxpayer, his/her representative, or any other unauthorized person, that he/she has such other information.* As a precaution it is advisable for the agent not to bring these documents with him/her to any meeting with the taxpayer or his/her representative (U.S. House Hearings 1979: 414).

Such intentional concealment of IRS information and behavior from the taxpayer was coupled with government officials' oft-stated desire to avoid the appearance, but not the reality, of harassment of taxpayers. Treasury Secretary Miller and Internal Revenue Commissioner Kurtz (U.S. House Hearings 1980: 34-35) averred that alternatives to withholding "would require millions of telephone calls, letters and visits, many involving small amounts of tax" which could "easily be regarded as harassment of small taxpayers" and could "generate massive tax-

payer resentment and jeopardize our system of voluntary compliance." In subsequent hearings the American Bankers Association asked (U.S. House Budget Comm. Hearing 1982: 100), "Are they not in effect asking the financial industry to do their harassing for them?" For government officials, that was the point. So using the financial industry (as employers had been used since 1943) not only shifted collection costs but also deflected political blame, further raising transaction costs to private citizens of reacting politically to additional federal encroachments upon their earnings.

Contrary to the reality of mandatory third-party extraction of income from wage earners, officials continued to portray the U.S. tax system as grounded in "voluntary" compliance. Commissioner of Internal Revenue Roscoe L. Egger Jr., testified in congressional hearings that "approximately 80 percent of taxes owed are reported and paid *voluntarily* without any IRS enforcement effort at all." Only in his written remarks did he allow that mandatory withholding underlies this "voluntary" behavior, stating (U.S. House Ways & Means Comm. Hearing 1982: 5, 10–11) that "this voluntary compliance results largely from a very workable system of tax administration rules based on withholding and information reporting." As Professor Charles Davenport testified (U.S. House Ways & Means Comm. Hearing 1982: 273), "Our system is said to be one of voluntary compliance, but for some time we have known that compliance is the highest where voluntarism is the least relied upon."

Finally, throughout the 1979, 1980, and 1982 hearings there was clear recognition by government officials of the incremental nature of institutional change. Sheldon S. Cohen, former Commissioner of Internal Revenue, noted that the American public had "gotten used to withholding." Calling withholding the "backbone of the system," he stated (U.S. House Budget Comm. Hearing 1982: 124), "It is not new. It is not a new tax; nobody can complain that it is a new tax." Officeholders viewed incrementalism as instrumental in achieving their long-run aims.¹⁶ Reflecting on the history of withholding—first social security, then the Victory tax, then the 1943 act—Representative Joseph L. Fisher (D., Va.) commented (U.S. House Hearings 1980: 217), "Maybe the moral is to bring this one in gradually."

Gradualism indeed has typified ongoing legislative efforts. Thwarted in the quest for mandatory withholding of interest and dividend income

¹⁶Regarding a related matter, Commissioner of Internal Revenue Roscoe L. Egger Jr. explained (U.S. House Ways & Means Comm. Hearing 1982: 19–20) that the IRS advocated a mandatory withholding tax on pensions, but that the IRS was promoting information reporting and, initially, voluntary withholding of taxes on pensions as a first step.

in 1979 and 1980, government officials waited to make the proposal again—in a “crisis” perhaps, or when they could produce a more appealing rationale for the measure, or when the proposal had stronger presidential or party backing.

In 1982 those conditions coalesced. The purported crisis was the budget deficit; the appealing rationale was the “fairness” of using withholding to make tax evaders pay rather than raising taxes on law-abiding citizens; strong executive backing came from President Ronald Reagan. The vehicle was section 301 of the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA] (P.L. 97-248, 96 Stat. 324, 3 September 1982) wherein Congress authorized 10 percent withholding on interest and dividends with certain exemptions for poor and elderly individuals. Its acknowledged purpose was taxpayer compliance.¹⁷ Representative Daniel D. Rostenkowski (D., Ill.), Chairman of the House Committee on Ways and Means, argued that “collecting taxes from people and from businesses who are now evading taxes is obviously the *fairest* way to produce additional revenue.” The ranking minority member of the same committee, Representative Barber B. Conable, Jr. (R., N.Y.), said that President Reagan had “laid his prestige on the line for this measure” (*U.S. Cong. Rec.-House*, 19 August 1982: 6555, 6630).

Transaction-cost augmentation was central to approval of this withholding measure. It was packaged with an omnibus tax bill, increasing the transaction costs to legislators and voters of resisting the provision. Despite repeated congressional efforts to allow a separate vote on the issue, the House of Representatives did not vote separately on the withholding section of TEFRA.¹⁸ Moreover, contrary to article 1, section 7 of the Constitution, the bill’s substantive provisions (including the withholding measure) did not originate in the House of Representatives at all but rather in the Senate Finance Committee. The

¹⁷The Senate Finance Committee, reporting Internal Revenue Service estimates “that 15 percent of dividend income and 11 percent of interest income is not reported by taxpayers” while “99 percent of wage income is reported by taxpayers,” concluded that “Withholding improves voluntary compliance” (*U.S. Senate Report* 1982: 228).

¹⁸Representative Norman E. D’Amours (D., N.H.) noted (*U.S. Cong. Rec.-House*, 19 August 1982: 22147) that “One hundred and fifty Members of this body have signed a letter to the Committee on Rules asking for a separate vote. An overwhelming number of our constituents . . . oppose withholding of interest and dividend taxes.”

Representative John E. Porter (R., Ill.) remarked the following year (*U.S. Cong. Rec.-House*, 17 May 1983: 12493) that withholding “was just one of 96 parts of the last year’s tax package, and, unfortunately, we in the House never had the opportunity to vote on the proposal separately. If it had been a free-standing proposal and not part of omnibus legislation, Congress most likely would have overwhelmingly defeated it, just as we did in 1980.”

Senate bill was tacked on to a minor House bill, and the package was sent to conference without House hearings or debate on the bill. The conference bill then returned to the House under a closed rule which precluded amendment or separate voting on its individual provisions. Through procedures described on the House floor as having "abrogated our constitutional responsibilities," the omnibus budget bill strategy permitted the withholding provision to become law despite a House vote two years earlier rejecting 404-4 the study of withholding on dividends and interest (*U.S. Cong. Rec.-House*, 19 August 1982: 22219). *Ex ante*, many in Congress considered tax enforcement through withholding to be less painful than new taxes as a way to narrow the budget deficit.

However, the new withholding provision was not less painful in practice. Public opposition was profound. By August 5, 1983, one month after withholding was to have taken effect under TEFRA, the Interest and Dividend Tax Compliance Act of 1983 (P.L. 98-67, 97 Stat. 369, 5 August 1983) *repealed* TEFRA's provision for withholding on interest and dividends. In its place Congress authorized expanded information reporting coupled with "backup withholding" of 20 percent in specific circumstances involving taxpayer noncompliance.

The repeal of the TEFRA withholding provision reflects the internal dynamics of determinants of transaction-cost augmentation. While variables discussed above impelled congressmen toward use of transaction-cost-increasing strategies to pass TEFRA, many misjudged the intensity of constituent hostility to the withholding provision. But perhaps the measure served its political purpose nonetheless. Since tax compliance provisions accounted for 21 percent of the additional revenue claimed to be generated by TEFRA, the evanescent authorization of interest and dividend withholding allowed Congress the political benefit without the political cost of claimed budget deficit reduction (*U.S. House Report No. 98-120*, 1983: 2).

Finally, the 1983 repeal of withholding on interest and dividends provides suggestive evidence regarding the long-term influence of transaction-cost augmentation and the path dependency of institutional change. Absent 40 years' experience of withholding, public opinion in 1983 might have opposed wage and salary withholding with equal intensity.¹⁹

¹⁹In 1982 Representative Daniel D. Rostenkowski (D., Ill.) remarked (*U.S. Cong. Rec.-House*, 19 August 1982: 6555), "The debate now in progress on interest and dividend withholding occurred 40 years ago on wage withholding. Now wage withholding is a popular system, and perceived as a relatively painless way to accurately pay taxes. I predict that in a few years, we will be able to say the same of interest and dividend withholding."

Entrenchment of the Machinery of Government

It is now a minimal problem to maintain a withholding system on salaries and wages, which is absolutely at the heart of our self-assessment technique of paying taxes.

—G. William Miller, Secretary of the Treasury
(U.S. House Hearings 1980: 23–24)

The question is, can such long-established and carefully contrived practices be reversed—and, more relevantly, are they likely to be reversed? In a representative democracy, the answer to the first question is unequivocally affirmative. Nonetheless, if the theory and evidence presented here are substantially accurate, the answer to the second question is unequivocally negative. The essence of transaction-cost augmentation is guided deflection of certain types of collective political action in order to facilitate establishment and continuation of policies often initially inconsistent with people's preferences. We have seen that the long-run result of such institutional change is authority-legitimizing ideological change that renders policy reversal increasingly unlikely.

One sobering result of the present study is its evidence of key public officials' extensive awareness of the dynamics of transaction-cost manipulation. As their published statements made clear, many officeholders deliberately sought the transaction-cost-increasing results of their income tax withholding policies. Along with the public, other officeholders—such as those in 1943 who did not understand the present-value issue—were targets of those transaction-cost-manipulating strategies.

The history of U.S. income tax withholding documented here is consistent with the theory discussed earlier in this article. We have seen that, on many levels, income tax withholding increases transaction costs to the public of understanding the magnitude of the income tax and of opposing it politically. Government officials always have regarded withholding as a seemingly "painless alternative" (U.S. House Hearings 1980: 35). Lacking an understanding of the concept of present value, many taxpayers do not perceive that withholding causes the real burden of their tax liability to be greater. Indeed, the common practice of overwithholding associates the payment of taxes with an apparent financial benefit rather than cost, distorting taxpayers' assessments of the actual costs and benefits of government activity. Consistent with a transaction-cost-manipulation model, the expected return of such overpayments makes people feel "happier" about sending in their tax returns on April 15. The very mechanism of withholding deflects blame from the government by requiring employers to initiate

and bear the cost of the forcible extraction of people's income. Piece-meal collection each payday from income the taxpayer never sees obscures the magnitude of the annual tax. And, because it is a forcible extraction, it raises the transaction costs to the public of expressing political resistance to taxes by not paying them.

In examining the process of passing the Current Tax Payment Act of 1943, we have seen that key variables identified by the theory as determinants of transaction-cost augmentation played their expected roles. The complexity of the withholding measure, the appealing rationale provided by wartime revenue needs, executive support, constituent support induced by purported tax forgiveness, ideologies shaped by the already expanded role of government, and lack of media publicity regarding the measure's transaction-cost-increasing features all contributed as expected to adoption of the Act. Consistent with the theory, the history of income tax withholding showed institutional experiences born of transaction-cost manipulation in turn influencing predominant public ideologies, thereby building long-run support for expanded government authority buttressed by additional transaction-cost-increasing institutions.

After 50 years of comprehensive withholding at the source of American workers' salaries, people are used to wage withholding; most no longer question it. The relevant institutional machinery is entrenched, both through its administrative apparatus and through its acceptance in the minds of most taxpayers. Some resistance does remain. Representative Bill Gradison (R., Ohio), for instance, stated (U.S. House Hearings 1980: 46) that "one of the greatest steps we can take toward holding down expenditures and making people aware of the cost to Government would be to reexamine our assumption that wages must be withheld upon." More recently (*Wall Street Journal* 1994), in conjunction with his proposal to replace the existing income tax with a flat tax, Representative Dick Armev (R., Texas) recommended elimination of withholding, calling it a "crucial, deceptive device" that has allowed government "to raise taxes to their current level without igniting a rebellion." But such voices are few. As ideologies accommodate altered institutional reality, as citizens' views about what ought to be come more nearly to reflect what is, government manipulation of political transaction costs provides one key part of the explanation of how such politico-economic change has occurred.

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