THE MYTH OF PRETAX INCOME

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THE MYTH OF OWNERSHIP: TAXES AND JUSTICE. By *Liam Murphy* and *Thomas Nagel*. New York: Oxford University Press. 2002. Pp. ix, 228. $25.

I. EXPOSING THE MYTH

What constitutes a fair distribution of the burdens of taxation among the members of a society? Even as politicians and academics vigorously debate the answer to that question, there is widespread agreement that all are asking the right question. In *The Myth of Ownership*, however, Liam Murphy[1] and Thomas Nagel[2] claim that everyone has been asking the wrong question. To ask about the fair distribution of tax burdens is to take the distribution of pretax incomes as "presumptively just," so that justice in taxation "is a question of what justifies *departures* from that baseline" (p. 15). But Murphy and Nagel claim that pretax income is a myth, and, as such, has no moral significance.

How can my pretax income be a myth, when I can read it on my W-2? Their argument goes as follows: Pretax income means income in the absence of taxes. But in the absence of taxes there would be no government, in the absence of government there would be anarchy, and in a state of anarchy no one would have any income.[3] Pretax income, then, must be zero — or, equivalently, there is no such thing as pretax income. If there is no such thing as pretax income, obviously people cannot be entitled to it. Instead, "[a]ll they can be entitled to is what they would be left with after taxes under a legitimate system, supported by legitimate taxation — and this shows that we cannot evaluate the legitimacy of taxes by reference to pretax income" (pp.

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3. P. 32.

> There is no market without government and no government without taxes .... In the absence of a legal system supported by taxes, there couldn't be money, banks, corporations, stock exchanges, patents, or a modern market economy — none of the institutions that make possible the existence of almost all contemporary forms of income and wealth.

Id.

32-33). In brief, justice in taxation is a matter of the distribution of after-tax incomes, not a matter of the distribution of tax burdens. More briefly still: "Outcomes, not Burdens" (p. 98).

To Murphy and Nagel, their way of framing the question is obviously correct and the burden formulation is clearly wrong — so much so that they find it "puzzling how anyone could have been attracted to [the dominant way] of thinking about tax justice" (p. 34). Their explanation of the puzzle is that people are enthralled by "everyday libertarianism" — "an unexamined and generally nonexplicit assumption" (p. 36) that one earns pretax income without any help from the government, so that the government bears a heavy burden of justification in taxing any of it away.[4]

I am persuaded that Murphy and Nagel are right and that everyday libertarianism is wrong — not as a debatable question of policy, but as an inescapable matter of logic.[5] I share their frustration that "the robust and compelling fantasy" (p. 176) of pretax income has such deep roots that it probably cannot be dislodged by logical arguments. That their efforts to refocus the debate are doomed is suggested by the fact — not noted by Murphy and Nagel — that the prominent economist Carl Shoup made precisely the same point as Murphy and Nagel in his public finance treatise more than thirty years ago, to no discernible effect.[6] For that matter, the point is implicit in Justice Holmes's famous remark, "I like to pay taxes. With them I buy civilization."[7] Perhaps times have changed, or perhaps the point will prove

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4. Pp. 31-37 (discussing and critiquing everyday libertarianism).

5. Their argument is only as good as their assumptions that (1) people would not be able to produce any income in a state of anarchy, and (2) there would be anarchy in the absence of taxes. Both assumptions are highly plausible.

6. CARL S. SHOUP, PUBLIC FINANCE 577-78 (1969), *quoted in* Michael J. Graetz, *Distributional Tables, Tax Legislation, and the Illusion of Precision*, *in* DISTRIBUTIONAL ANALYSIS OF TAX POLICY 15, 25 (David F. Bradford ed., 1995):

> To say, for example, that households with before-tax incomes between $2,000 and $5,000 pay 12 percent of that income in taxes . . . is to make a statement that is without significance because it is conceptually invalid. It is conceptually invalid because it postulates, for implicit comparison, a state of affairs in which there are no taxes whatever . . . hence impliedly no government services, not even of the minimum type and amount necessary to assure existence of the society. . . . [This] objection is conclusive.

Kenneth J. Arrow has made a similar point:

> There are large gains to social interaction above and beyond what the individuals and subgroups could achieve on their own. The owners of scarce personal assets do not have a private use of these assets which is considerable; it is only their value in a large system which makes these assets valuable. Hence, there is a surplus created by the existence of society as such which is available for redistribution.

Kenneth J. Arrow, *Nozick's Entitlement Theory of Justice*, 7 PHILOSOPHIA 265, 278-79 (1978).

7. *See* RANDOLPH E. PAUL, TAXATION FOR PROSPERITY 277 (1947) (quoting Oliver Wendell Holmes, Jr.) (internal quotation marks omitted); *see also* Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) ("Taxes are what we pay for civilized society.").

more persuasive when expanded to book length; but more likely, everyday libertarianism is here to stay. Murphy and Nagel agree with that gloomy prediction,[8] and their resulting frustration is evident in the way they repeat their basic point — by their own admission, "ad nauseam" (p. 164) — throughout the book. Cassandra-like, they know they are right, but that few will believe them.

A striking example of the influence of everyday libertarianism (not mentioned by Murphy and Nagel) is Congress's disproportionate concern about earned income tax credit ("EITC") cheating relative to concern about other forms of income tax cheating. In 1997, Congress directed the Treasury to spend up to $716 million over the next five fiscal years (1998 through 2002) on EITC "enforcement initiatives."[9] As a result, returns claiming the EITC accounted for 44 percent of all audits in 2000, and in 1999 taxpayers with incomes below $25,000 were more likely to be audited than taxpayers with incomes above $100,000.[10] Cheating on the EITC probably represents less than 10 percent of the total income tax gap (i.e., the amount of tax owed but not collected),[11] so it is virtually inconceivable that such a heavy emphasis on the EITC gives the government the most bang for its enforcement dollar. What, then, explains the EITC crackdown? The EITC is refundable, which means it results in a net transfer from the government to the person claiming the credit if the EITC exceeds the person's precredit income tax liability (as it usually does). Thus, cheating on the EITC typically results in an unwarranted payment from the government to the cheater. Other (more traditional?) forms of tax cheating result in a taxpayer's failure to make a legally mandated payment to the government. Both results are contrary to law, of course, and one might suppose that one person's receiving a dollar too much EITC is no worse than another person's paying a dollar too little tax. Under the influence of everyday libertarianism, however,
Congress seems to believe that a dollar too much EITC received *is* worse than a dollar too little tax paid. An underpayment of tax merely allows the taxpayer to keep more of his pretax income, and the government's right to take away any of his pretax income was dubious to

8. "We recognize that it is a lot to hope that this philosophical point should be psychologically real to most people." P. 176.

9. Balanced Budget Act of 1997, Pub. L. No. 105-33, § 5702, 111 Stat. 251, 648 (1997).

10. David Cay Johnston, *Rate of All I.R.S. Audits Falls; Poor Face Special Scrutiny*, N.Y. TIMES, Feb. 16, 2001, at A1.

11. U.S. DEP'T OF THE TREASURY, MANAGEMENT ADVISORY REPORT: ADMINISTRATION OF THE EARNED INCOME CREDIT (2000) (comparing one study's estimate of EITC overclaims of $9.3 billion for 1997 with another study's estimated total income tax gap of $93.2 to $95.2 billion for 1992), *available at* http://www.ustreas.gov/tigta/reports/200040160fr.pdf.

begin with. By contrast, the everyday libertarian has no sympathy for the EITC cheater's attempt to obtain an illegal transfer payment.

To a reader persuaded by the book's critique of everyday libertarianism, two questions present themselves. How would the tax system change if Murphy and Nagel succeeded in replacing the current debate about tax burdens with a debate about outcomes? And what could be done to improve their prospects of changing the terms of the debate? In the remainder of this Review, I address those questions.

II. WOULD A DIFFERENT QUESTION PRODUCE A DIFFERENT ANSWER?

Today, almost everyone (except Murphy, Nagel, and this reviewer) agrees that fairness in taxation requires an appropriate distribution of the tax burden, starting from the baseline of pretax income.[12] Despite this agreement on the question, there is no agreement on the answer. To some, justice requires an income tax base, while others insist that consumption is the only fair tax base. To some, progressive marginal tax rates are morally required; to others progressive rates are anathema. Just as the current agreement on the (wrong) question does not produce agreement on the answers, no particular tax structure necessarily follows from Murphy and Nagel's focus on outcomes. Nevertheless, asking a different question is likely to produce a different set of answers.

As an example, consider the debate early in the presidency of George W. Bush over how taxes should be cut in response to the (late lamented) federal budget surplus. The President's position, which largely prevailed in Congress,[13] was that income tax burdens should be decreased by the same percentage across the board. If the government could get by with six percent less revenue, then a rich person currently paying $100,000 in income tax would have his liability reduced by $6,000, a middle-income person currently paying $10,000 would receive a $600 reduction, and a lower-income taxpayer currently paying $1,000 would have his liability reduced by $60. This is a plausible position, *if* fairness in taxation is about the distribution of tax burdens.

12. The literature on optimal income taxation is an important exception. As Murphy and Nagel acknowledge, this literature "approaches the topic [of tax justice] in the right way, investigating outcomes rather than the distribution of burdens." P. 136. The seminal work in the field is J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971). For an excellent book-length exploration of the field, see MATTI TUOMALA, OPTIMAL INCOME TAX AND REDISTRIBUTION (1990). For a nontechnical introduction to optimal income tax analysis, see Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis*? 53 TAX L. REV. 51 (1999).

13. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001). For the President's original proposal, see George W. Bush, *A Blueprint for New Beginnings: A Responsible Budget for America's Priorities*, Mar. 1, 2001, *available at* LEXIS, Tax Analysts Tax Notes Today Library, 2001 TNT 41-13.

If the existing distribution of burdens ($100,000, $10,000, $1,000) was fair before the surplus, and if the surplus is the only change in circumstances, then it seems fair to retain the pre-surplus liability ratios under the new conditions. If, however, the right question is about the distribution of after-tax incomes, the intuitively fair thing might be to cut taxes so that taxpayers at all income levels enjoyed the same percentage increase in after-tax income. Cases could be made for much more progressive distributions of the budget surplus — such as distributing the surplus pro rata or even using the entire surplus to increase the after-tax incomes of the poorest members of society. Using the surplus to increase everyone's pretax income by the same percentage is the *least* progressive plausible answer, under an outcomes-based approach.

The difference between an across-the-board decrease in tax liabilities and an across-the-board increase in after-tax incomes is illustrated by the following example. Imagine a country with just two sorts of taxpayers, the Highs and the Lows, with an equal number of each. Each High taxpayer has $100,000 of pretax income and pays $40,000 tax (representing an average rate of 40%). Each Low taxpayer has $25,000 of pretax income and pays $5,000 tax (representing an average rate of 20%). The government thus collects $45,000 tax from each High-Low pair. Now suppose that for some reason — perhaps a dramatic increase in bureaucratic efficiency — the government decides it can get along perfectly well on 20% less revenue. This means the $45,000 tax liability of each High-Low pair can be reduced by $9,000. If each taxpayer's liability is to be reduced by 20% — the result suggested by the burdens question — a High taxpayer will receive an $8,000 tax cut and a Low taxpayer will receive a $1,000 tax cut. If each taxpayer's after-tax income is to be increased by the same percentage — the least progressive of the results suggested by the outcomes question — the appropriate tax cut will be quite different. Before the tax cut, each High-Low pair had $80,000 of after-tax income ($60,000 for each High and $20,000 for each Low), and the government can now afford to increase their combined after-tax income by $9,000, or 11.25%. To increase the after-tax incomes of High and Low by the same 11.25%, the government should give High a tax cut of $6,750,[14] and Low a tax cut of $2,250.[15] Even under this least progressive of plausible answers to the outcomes question, Low's tax cut is more than twice as large as under the most likely answer to the burdens question. To generalize the point: distributing the benefit of a tax cut in proportion to after-tax incomes, rather than in proportion to tax

14. This increases High's after-tax income to $66,750, which is an increase of 11.25% from $60,000.

15. This increases Low's after-tax income to $22,250, which is an increase of 11.25% from $20,000.

liabilities, will be advantageous to Low whenever Low's after-tax income is a higher percentage of High's after-tax income than Low's tax liability is of High's tax liability — a condition which will obtain whenever the existing tax system is progressive.

The above analysis suggests that tax cuts will generally be distributed more progressively if the focus is on outcomes than if the focus is on burdens. What about the distribution of tax increases? Take the same starting situation as in the example above, but this time assume the government needs an additional $9,000 revenue from each High-Low pair. If the burdens question suggests a proportionate increase in tax liabilities, the government will collect $8,000 more from High and $1,000 more from Low. If the outcomes question suggests a proportionate decrease in after-tax incomes, the government will collect $6,750 more from High and $2,250 more from Low.[16] Thus, it is not inevitable that the outcomes question will produce more progressive results than the burdens question. Perhaps all that can be said with a high level of confidence is that the different questions will (not surprisingly) tend to produce different answers. Still, my intuition is that the outcomes question will tend to produce more progressive results than the burdens question, even in the case of tax increases. After all, there are a number of plausible answers to the outcomes question, of which distributing a tax increase in proportion to after-tax incomes is the least progressive. A focus on outcomes might lead most of the electorate to conclude that the burden of the tax increase should fall entirely, or nearly entirely, on the Highs — especially if any additional tax on the Lows would drive them below the poverty level.

The preceding discussion considers how the burdens and outcomes questions might produce different results when tax revenues are to be increased or decreased in response to changing budgetary conditions. Just as important, however, are the different responses the two questions are likely to generate to changes in levels of income inequality. In 1980, the average CEO of a major public corporation earned forty-two times as much as the average worker; by 2000, that had increased to 531 times as much.[17] This is a striking example of the general increase in income inequality over the last two decades. In 1979, the highest quintile of American households received 46% of all pretax income and the lowest quintile received 5%; by 1997, the highest quintile's share had risen to 53% and the lowest quintile's share had fallen to 4%.[18] Over the same period the share of pretax income received by the top 1% of households almost doubled, from 9% to

16. This would reduce High's after-tax income from $60,000 to $53,250, and Low's from $20,000 to $17,750. Both are 11.25% reductions.

17. Editorial, *CEOs: Why They're So Unloved*, BUS. WK., Apr. 22, 2002, at 118.

18. CONG. BUDGET OFF., EFFECTIVE FEDERAL TAX RATES, 1979-1997, at 7 fig.1-6 (2001).

16%.[19] How should the tax system respond to this growing inequality? Under the burdens question, it is not obvious that the tax system should respond at all, as long as the growing inequality does not necessitate revenue-driven tax law changes. Once we have determined the appropriate tax liabilities to impose on persons at every income level, there is no reason to revisit those determinations just because the numbers of persons at various levels have changed. In sharp contrast, to ask the outcomes question is to raise the possibility that the tax system might be used to counteract growing pretax inequality. If we think it is just (or at least not unjust) for CEOs to earn 42 times as much as the average worker, but that it is unjust for CEOs to earn 531 times as much, we might change the tax laws in ways which would push after-tax outcomes in the right direction.[20] The progressivity of the current income tax makes the distribution of after-tax income somewhat less unequal than the distribution of pretax income.[21] Nevertheless, in 1997 the after-tax income of the highest quintile of American households was more than ten times that of the lowest quintile — compared to less than seven times in 1979.[22] Obviously, the income tax could be used much more aggressively in reducing after-tax income inequality.

Murphy and Nagel would agree with my belief that a focus on outcomes rather than burdens would tend to produce more progressive tax (and transfer) policies, but they also reach a number of specific conclusions about the structure of a fair tax system. For example, they conclude that an income tax is preferable to a consumption tax (pp. 96-129), that the tax system should be significantly progressive (pp. 130-41), that gratuitous transfers should be taxed as income to recipients and should not be deductible by transferors (pp. 142-61), and that a number of itemized deductions should be converted to credits (pp. 126-28, 165). Their discussions of these issues are thoughtful, but they lack the compelling — almost syllogistic — force of their argument for focusing on outcomes rather than on burdens.

It is interesting to read how a focus on outcomes would lead Murphy and Nagel to design a tax-and-transfer system; but other thoughtful people also concerned about outcomes might reach different conclusions — just as some people concerned about burdens favor a progressive income tax while others concerned about burdens favor a flat rate consumption tax. In their discussions of particular design

19. *Id.*

20. This might involve both an increase in the tax rates generally applicable to very-high-income taxpayers, and narrowly targeted changes to the tax treatment of stock options and other forms of compensation favored by corporate executives.

21. CONG. BUDGET OFF., *supra* note 18, at 7 fig.1-6 (distribution of pretax income); *id.* at 13 fig.1-12 (distribution of after-tax income).

22. *Id.* at 13-15 (text accompanying Figure 1-12).

issues, Murphy and Nagel seem to assume the outcomes question answers itself more than it really does.

III. CHANGING THE TERMS OF THE DEBATE

In the end, everyday libertarianism and the myth of pretax income may be too firmly entrenched to be dislodged by any means. In a hopeful vein, however, I offer three suggestions designed to increase the attention paid to outcomes in tax policy debates.

A *Be Careful to Avoid Being Misunderstood*

Conservative reviewers of *The Myth of Ownership* have been outraged. Stephen Moore of the Cato Institute offered two summaries of the book's central claim: "Americans should stop whining so much about taxes and instead be happy with the money that the government, in its benevolence, allows us to keep," and "[t]he government owns the fruits of your labor, and your real income is what Uncle Sam permits you to keep."[23] Similarly, Richard Epstein described the book as claiming that "property is a myth," and that "our rights [are] entirely contingent on government."[24] These are not fair characterizations of the book. Rather than claiming that property is a myth and that the government would be entitled to keep all the fruits of one's labor were it so inclined, Murphy and Nagel write that

> [p]eople do have a right to their income, but its moral force depends on the background of procedures and institutions against which they have acquired that income — procedures that are fair only if they include taxation to support various forms of equality of opportunity, public goods, distributive justice, and so forth. (p. 74)

Late in the book, they disassociate their argument from "the claim that the entire social product really belongs to the government, and that all after-tax income should be seen as a kind of dole that each of us receives from the government, if it chooses to look on us with favor" (p. 176). Clearly, Murphy and Nagel would consider a system in which the government confiscated everyone's income (and gave it to whom?) unjust. Nevertheless, it is understandable that persons might misread them, given that (1) they do not explicitly disavow the government-is-entitled-to-everything position until page 176 of a 190-page text, and (2) their chosen title — *The Myth of Ownership* — promotes

23. Stephen Moore, *In Their Own Words*, NAT'L REV. ONLINE, Apr. 23, 2002 (reviewing *The Myth of Ownership*), *at* http://www.nationalreview.com/script/printpage.asp?ref=/moore/moore042302.asp.

24. Richard A. Epstein, *Myth-Making on Taxes*, NAT'L REV., July 1, 2002, at 49 (reviewing *The Myth of Ownership*).

that misreading.[25] In fact, the title does not accurately reflect their argument. They do not claim that ownership is a myth, but only that pretax income is a myth. An accurate — albeit less catchy and provocative — title would have been "The Myth of Pretax Income." Even with the most careful presentation, it would be difficult to persuade the American public that pretax income is a myth. The task becomes impossible, though, if the packaging of the argument leads people to misperceive it as an argument that all private property is a myth and that the government is entitled to claim the entire gross national product.

B. *Institutionalize Data on the Distribution of After-Tax Income*

There is a wealth of data available from government sources on the distribution of tax burdens. Distributional analyses of the effects of proposed legislation, prepared by the Staff of the Joint Committee on Taxation ("JCT") and by Treasury's Office of Tax Analysis ("OTA"), are regularly used by Congress during legislative deliberations.[26] The Congressional Budget Office ("CBO") also provides distributional analyses, although not generally in connection with proposed legislation.[27] Finally, the IRS provides a mass of information on the distribution of tax burdens in its Statistics of Income publications.[28] It is surprisingly hard, however, to find information on the distribution of after-tax income[29] — and information on the effect of proposed legislation on the distribution of after-tax income is usually nonexistent. In an essay published in 1995, Michael Graetz suggested that distributional analyses should focus on after-tax income,[30] but to date his suggestion has not been adopted. The most practical thing that could be done in the short term to promote an interest in outcomes rather than burdens would be the adoption of Graetz's suggestion — either by legislation or by the JCT Staff and the OTA on their own initiative.

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25. It is possible that, rather than being genuinely confused, Moore and Epstein purposely mischaracterized the book's argument for rhetorical purposes. Even if the mischaracterizations were intentional, they were made plausible by the title of the book and by the book's failure to disclaim the government-owns-everything argument earlier and more forcefully.

26. Graetz, *supra* note 6, at 19-24.

27. *Id.* at 20.

28. The IRS Statistics of Income ("SOI") program regularly publishes statistical analyses based on tax return information. Recent studies are available, under the heading of "tax stats," at http://www.irs.ustreas.gov.

29. Contrary to the usual practice, a considerable amount of information on the distribution of after-tax income is contained in CBO reports. *See* CONG. BUDGET OFF., *supra* note 18.

30. Graetz, *supra* note 6, at 30 ("Ultimately it is the impact of legislation on the distribution of aftertax incomes that should be of concern in analyzing distributional consequences of legislative changes.").

The obvious analogy is to the institutionalization of the tax expenditure concept in the form of tax expenditure budgets regularly prepared by both the JCT Staff and by the Treasury Department.[31] The tax expenditure budgets remind Congress that the budgetary costs of indirect subsidies contained in the Internal Revenue Code — in the forms of exclusions, deductions, and credits — are just as real as the costs of direct cash subsidies.[32] The early proponents of the tax expenditure concept generally hoped that an institutionalized tax expenditure budget would dampen legislative enthusiasm for tax expenditures, as Congress came to understand their true costs.[33] Tax expenditures are very much alive and well today, but it is impossible to say whether their growth would have been even more exuberant without the periodic reminders of their cost. The limited restraining effect — if any — of tax expenditure budgets suggests that a proponent of outcomes-based tax policy should not expect too much from the regular production of distributional analyses of after-tax income. Congress can always ignore the information if it chooses. The availability of such analyses may not be sufficient to change the terms of the debate, but it is clearly necessary. In the absence of information on outcomes, outcomes-driven tax legislation is impossible. An encouraging aspect of the analogy to the tax expenditure budget is that the modest goal does not seem out of reach. It was possible once to persuade Congress to spend a trifling amount of money to produce some interesting information; it might be possible to do so again. It might even be easier this time, since the very idea of tax expenditures was (and still is) controversial, whereas nobody doubts the existence or importance of after-tax income.

C. *Designing the Tax System to Decrease the Power of the Myth*

The power of the myth of pretax income may depend on the design of a tax system. The myth seems most powerful when a taxpayer receives the entire amount of her pretax income in cash, and then must hand over a portion of it to the government. This is the case with forms of income not subject to withholding, such as interest, dividends,

31. The annual preparation and submission of a tax expenditure budget by the Executive Branch is mandated by statute. 31 U.S.C. § 1105(a)(16) (2000). For a recent example of the nonmandatory tax expenditure budget prepared by the JCT Staff, see STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2002-2006 (Comm. Print 2002).

32. On the tax expenditure concept generally, see STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985). *See also* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

33. *See, e.g.*, STANLEY S. SURREY, PATHWAYS TO TAX REFORM 179-207 (1973).

and self-employment income.[34] The myth seems less powerful with respect to wages and salaries, which are subject to withholding.[35] For an employee whose salary is subject to withholding, pretax income is just a number on her pay stub; it lacks the visceral reality of take-home pay.[36] At the other extreme from income not subject to withholding, the myth is vanquished by the form of the employer's share of the social security wage tax.[37] This portion of the social security tax is imposed on the employer (although economists agree the economic burden of the tax falls on the employee[38]), so that the amount of the tax is not nominally a part of the employee's pretax income. With the amount of this tax not included in pretax income, few employees understand the tax as depriving them of something to which they are presumptively entitled.

These differences suggest that one way of combating the myth of pretax income would be to design taxes in ways that lessen the power of the myth. Withholding is better than no withholding, and shifting the nominal burden of taxation away from individuals may be better still. If one's view of tax justice requires progressivity, however, the strategy exemplified by the employer's social security tax will have limited appeal, because it is difficult or impossible to design a satisfactorily progressive tax system if taxes are not nominally imposed on individuals.[39]

That leaves withholding as the most promising means of combating the myth. Wages have been subject to withholding since World War II,[40] and the myth of pretax wages has nevertheless survived, but imagine how much more powerful the myth might be today without withholding. Very likely, without withholding, the myth would have

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34. *But see* I.R.C. § 3402(p)(3)(B) (2000) (imposing "backup" withholding on interest and dividends under limited circumstances).

The myth of entitlement is probably stronger still with respect to estate and gift taxes. A taxpayer has his hands on interest and dividend income for only a few months before the income tax becomes due, but a taxpayer may have held property for decades — thus strengthening his sense of absolute entitlement — before a transfer tax becomes due with respect to the property.

35. *See* I.R.C. § 3402 (2000) (imposing the withholding requirement on wages, but not on income from other sources).

36. As Edward J. McCaffery has explained, people are less pained by — and thus less resistant to — "pay[ing] a tax imputedly, by never receiving money in the first place, rather than directly, by first receiving money and then having to give some of it back." Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1875 (1994).

37. I.R.C § 3111 (2000).

38. HARVEY S. ROSEN, PUBLIC FINANCE 285-86 (4th ed. 1995).

39. *See* Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 2 CHAP. L. REV. 197, 200-02 (1999) (explaining that a retail sales tax or a value-added tax cannot be graduated according to an individual's level of consumption).

40. Withholding was introduced by the Current Tax Payment Act of 1943, Pub. L. No. 78-68, 57 Stat. 126 (1943).

made a broad-based income tax impossible. In 1940, at the beginning of World War II, only about seven million Americans had any income tax liability; by 1945, the tax rolls had expanded to more than forty-two-million Americans.[41] The financing of the war necessitated the conversion of the income tax to a mass tax. The conversion was politically possible because of the popularity of the war effort, and because the introduction of wage withholding lessened the psychological burden of the tax. As David Brinkley noted, "[P]eople were paying their taxes with not much resistance because they were paying with money that they had never even seen. The term 'take home pay' now entered the language."[42] The weakening of the myth of pretax income by withholding was essential to the continuation of the income tax as a mass tax after the war emergency had ended.[43]

The myth's power might be further reduced if withholding at the source could be extended to other types of income, most notably interest and dividends. There is, however, a major problem with this strategy. Once withholding is firmly established it decreases the force of the myth, but the myth makes it extremely difficult to establish withholding in the first place. Absent a fiscal emergency comparable to World War II, significant extension of withholding may be impossible. That seems to be the lesson of the short, unhappy life of interest and dividend withholding during the early 1980s. The Tax Equity and Fiscal Responsibility Act of 1982 required payors to withhold income tax (at the rate of 10 percent) on most interest and dividend payments.[44] This was followed, almost immediately, by a massive public outcry — stirred up by the American Bankers Association — against withholding.[45] Members of Congress received up to 750,000 pieces of constituent mail a day on the issue — more than the volume generated by Watergate.[46] Skillfully exploiting the myth of pretax income, the bankers persuaded millions of depositors that withholding was a new tax, rather than simply a means of collecting an existing tax. Despite widespread media denunciations of the bankers' tactics[47] and the resis-

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41. Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685, 686 (1989) (citing BUREAU OF THE CENSUS, U.S. DEP'T. OF COMMERCE, SER. NO. Y402-411, HISTORICAL STATISTICS OF THE UNITED STATES 1110 (1975)).

42. DAVID BRINKLEY, WASHINGTON GOES TO WAR 219 (1988).

43. *See* Jones, *supra* note 41, at 730 ("By implementing an unobtrusive means for the collection of a direct tax, the U.S. government succeeded not only in financing World War II, but also in sustaining the income tax on a mass scale after V-J Day.").

44. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 301, 96 Stat. 324, 576-85 (1982).

45. Jonathan Alter, *Behind the Banks' Victory*, NEWSWEEK, May 2, 1983, at 28.

46. *Id.*

47. *See, e.g., id.* ("[T]he banks inaccurately portrayed withholding as a new tax . . . ."); *Brave Democrats and Withholding*, N.Y. TIMES, Apr. 19, 1983, at A22 ("Of all the agitating

tance of the chairs of both tax-writing committees,[48] the campaign for repeal succeeded in 1983 with the passage of the ironically named Interest and Dividend Tax Compliance Act.[49] The lesson of this history? Perhaps that little short of a world war can create a political climate in which major reforms designed to reduce the power of the myth of pretax income are possible.

If major extensions of withholding were politically feasible, there would be an interesting moral question as to their legitimacy. The idea behind expanded withholding is that two wrongs might make a right — that taxpayers' misperception that a tax system featuring withholding is fundamentally different from a tax system lacking withholding should be used to counteract their misperception that pretax income is real (and that they are presumptively entitled to all of it). Whether the worthy end justifies the devious means is a question on which reasonable people may differ.[50] The point is moot, though, as long as expanded withholding remains politically impossible.

IV. CONCLUSION

Very early in *The Myth of Ownership*, Murphy and Nagel observe that questions of tax justice "have generated less sophisticated discussion, from a moral point of view, than other public questions that have a moral dimension" (pp. 3-4). As an occasional contributor to the literature on fairness in taxation, I ruefully concede the accuracy of their judgment. *The Myth of Ownership* significantly increases the sophistication of the discussion.

For those who continue to believe that tax justice is a matter of the distribution of burdens relative to pretax income, the next step should be to respond to Murphy and Nagel's actual argument — rather than

distortions the bankers have circulated, the most flagrant is that withholding is a new tax. That's not merely distortion but a lie."); *A Charter for Evasion*, THE ECONOMIST, Apr. 23, 1983, at 25 ("The response of many banks . . . was to launch an unscrupulous campaign which suggested to depositors that they would be losing substantial sums that belonged to them."); *Day of Reckoning* . . ., WASH. POST, Apr. 15, 1983, at A20 ("[M]any people have been led by the banks' own propaganda to believe that a new tax is being imposed.").

48. News Release, *Dole Confronts Bankers on Withholding*, 18 TAX NOTES 776 (1983). In a speech to the American Bankers Association, Senate Finance Committee Chairman Robert Dole remarked, "A constituent writes me to criticize your organization's campaign, saying 'the impression is certainly created that the withholding constitutes some new form of tax and imposes some horrendous new burdens on savers. I agree . . . . *Id.* at 776; *Voting the Bankers' Way*, TIME, May 30, 1983, at 12 (" 'Today we are conceding control of the tax system to a special interest that has won the day largely by deceiving American taxpayers.' " (quoting Ways and Means Committee Chairman Dan Rostenkowski)).

49. Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, 97 Stat. 369 (1983).

50. For one view, see McCaffery, *supra* note 36, at 1943 (discussing the ethics of taking advantage of cognitive errors in furtherance of good tax policy goals, and concluding that the tactic is "fraught with dangers" and "runs afoul of basic moral notions").

to mischaracterize their position (inadvertently or intentionally). For those who are persuaded by Murphy and Nagel's basic point, there are two projects worth pursuing. One is to develop one's own answer to the question of how taxation can further the goal of a fair distribution of after-tax outcomes — an answer which may be very different from Murphy and Nagel's. The other is to help persuade Congress and the American public that the outcomes question is the right question. A first step in that direction would be to institutionalize — in Congress and the Executive Branch — the regular preparation and dissemination of distributional analyses of after-tax incomes.