

# Why a Big Tax Refund Shouldn't Excite You

It's the dreaded season once again. About this time of year, I usually write something about taxes. What can I say? After hours of working through my taxes and considering how much of my paycheck was eaten by the black hole of government projects, it's hard to stop thinking about our tax system.

Unfortunately our tax system is also widely misunderstood. You don't have to go far on the internet to see people celebrating their big refunds or mourning their small refunds. This impulse, while understandable, is misplaced. A big refund is not a good thing. To understand why, you have to understand the idea of withholding.

## Withholding Your Money

Why does the IRS issue tax refunds at all? Simply put, you get a refund because sometimes the IRS collects more money from you than you owe. There is no reason our system has to allow for this though.

This system is called withholding. The idea is the government withholds some of your pay (to pay estimated taxes) and releases it back to you if too much was withheld.

Before 1943, the US government didn't collect taxes from paychecks. Instead, taxpayers received their full check and were able to put some of it away at the end of the year to pay taxes.

During World War II, the withholding system was devised as a way to further finance the war effort. By taking money right away, rather than waiting to the end of the year, the government would have more cash on hand for wartime spending.

Interestingly, economist Milton Friedman, often a champion of small government policies, was a key developer of the withholding scheme. Though Friedman never apologized for the system, he did [express regret](#) that it continued into peacetime.

At this point you may be wondering why it matters whether the government withholds the money. After all, if someone before 1943 owed \$1,000 in taxes at the end of the year, and they set that money aside to pay taxes, why would it matter if the government (rather than the individual) held onto it until the end of the year? Either way the taxpayer doesn't spend it, so who cares?

Well, first, there is the issue that the government could withhold too much money from someone's paycheck. In that case, if someone needs excess withheld money today, but the government is holding onto it until April, then he's simply out of luck.

This is one reason you don't want a big refund. All a big refund means is the government was holding on to a big chunk of your money all year and you didn't have access to it. But this is only the beginning of the problem of government withholding.

## **An Interest-Free Loan**

Another reason a big refund should bother you is it can literally translate to you being poorer than if you had a small refund. Why?

Well remember, not having access to your money means you don't have the opportunity to use it today. Imagine I give you two options. You can have \$100 today or \$100 in a year. Which is better? Even ignoring inflation, it's certainly best to have the money today. If you get the money today you can use it or you could simply hold onto it for a year. It's an all-around

better option for this reason.

The fact that money today is preferable to money tomorrow, to quote one of my previous articles, is “what economists call the time value of money. A sum of money today is worth more than that same amount of money some time in the future. In fact, you can see more evidence of this by thinking about borrowing money.

When you (or a business) borrows money, you are accepting to receive a sum of money today (the loan) in exchange for paying back a *larger* sum of money in the future (the loan repayment *plus interest*). When individuals pay interest, they are agreeing that \$100 today is worth more than \$100 a month from now.”

So now that we understand money today is worth more than money tomorrow, we can see why a big refund is such a problem. A \$3,000 refund means that the government held \$3,000 which belonged to you all year, and the government was able to earn interest on this money while you were not.

In other words, if you kept your money and put it in a 12 month CD (Certificate of Deposit) which earned 3% annual interest, you would be able to earn \$90. With that money withheld, you get nothing.

So, if you got a huge refund, don't celebrate! You should reflect instead. In the usual employment situation, employers have workers fill out a form which decides how much of their money gets withheld each year. This form is called a W-4 form. It may be the case that when you did your W-4, you filled it out in such a way that too much is being withheld.

**But Beware the Government's Double**

# Standard

A wise person reading this article may be tempted to find ways to get as little money withheld as possible. If a big refund means you gave the government an interest-free loan, then a negative refund must be a good way to earn extra interest, right? Unfortunately no.

While paying in a little bit of money at the end of the year means you were able to hold more money and earn more interest, the government makes sure to penalize you if you do this too much.

The rules vary depending on the situation, but if you underpay withholding taxes too much during the year, the government hits you with a penalty.

Why would the government penalize you for paying what you owe when you owe it rather than before you owe it? The government also understands that they are able to earn more interest when they withhold more of your money. So, to discourage people from minimizing withholding, they penalize anyone who “underpays.”

Ironically, the government never pays out a bonus to people when they overpay throughout the year—regardless of the amount. This amounts to a sort of “heads I win, tails you lose” double standard whereby the onus is on the taxpayers to figure out how much they have to pay in. If you underpay, it’s your fault and the government penalizes you. If you overpay, that’s also your fault and the government will take the interest-free loan—thank you very much.

So, if you have a \$0 refund this year, rejoice. It means you got to keep more of your own money, and you dodged giving an interest-free loan to Uncle Sam.

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