TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

HEARINGS

BEFORE THE

SPECIAL COMMITTEE ON TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS

FIRST SESSION

PURSUANT TO

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TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

TUESDAY, FEBRUARY 7, 1939

UNITED STATES SENATE,
SPECIAL COMMITTEE ON TAXATION OF
GOVERNMENTAL SECURITIES AND SALARIES,
Washington, D. C.

The special committee met, pursuant to recess, at 10 a. m., in the committee room of the Senate Finance Committee, Senate Office Building, Senator Prentiss M. Brown, chairman, presiding.

The CHAIRMAN. The committee will be in order.

We are devoting this week largely to the hearing of those who are opposed to the recommendations made by the administration.

Mr. Tobin, who has consulted me regarding the program, has given me an order of appearance this morning, which consists of Mr. Tremaine, the comptroller of the State of New York, Dr. Lutz, of Princeton University, Mayor LaGuardia, followed by others. That program will be followed.

Mr. Tremaine, we will be very glad to hear from you.

STATEMENT OF MORRIS S. TREMAINE, COMPTROLLER OF THE STATE OF NEW YORK

Mr. TREMAINE. Mr. Chairman and gentlemen of the committee: If the committee please, by way of establishing my qualifications to speak from experience on the subject under consideration, may I simply state that I have been comptroller of the State of New York for the past 12 years. The office of State comptroller is one of only four that are filled by State-wide election.

The people of my State have seen fit to elect me to that office seven consecutive times—a record for the entire history of the State.

The comptroller of the State of New York, among his various other duties, is by law the sole trustee of the sinking funds and other investment funds belonging to the State, amounting in the aggregate to something over $250,000,000. Approximately four-fifths of the securities in the entire portfolio represent purchases made by me. We believe we have something of a world's record, in that since I have been comptroller not $1 of principal or interest has been lost through default or otherwise. The average interest yield is still approximately 4 percent, and, at current quotations, there is a marketable profit of something like $30,000,000.

Another important function of the New York State comptroller is that he superintends the fiscal affairs of the State's 1,600 municipalities—counties, cities, towns, and villages—with the exception of the cities of New York, Buffalo, and Rochester. Each of the fiscal officers

of these municipalities is required to file annually with the State comptroller a sworn statement covering in detail the financial operations of the previous fiscal year. In addition, expert auditors from the State comptroller's office examine the books of these various municipalities to verify the correctness of these statements and offer constructure guidance in their financial management. So that we have a constant and intimate association with, and expert knowledge of, the fiscal problems of the States governmental subdivisions.

I speak of experts, because the business world frequently comes in and takes these men because of their complete knowledge of the situation.

About 2 weeks ago I considered it my duty as the State's chief fiscal officer to communicate to these 1,600 fiscal officers some of my thoughts—purely from an economic standpoint—concerning the legislation now under consideration by your committee. With your permission, and with the thought that you might like to have these views before you on the record, I should like to take this opportunity to read that letter at this time. I quote:

DEAR SIR: You are, of course, aware of the current proposal in Congress to remove by statute the tax-exempt feature on future issues of Federal, State, and municipal securities. You also know that our attorney general has organized some 40 other State attorneys general in opposition to this proposal on constitutional and legal grounds.

I do not consider myself competent, nor do I propose to discuss its constitutional or political aspects. But, as chief fiscal officer of the State of New York, I do consider it my duty to forewarn you of the serious financial burden such a statute would inflict upon your municipality.

May I simply remind you of these facts:

1. Existing tax exemption makes a price difference of about three-fourths of 1 percent on bond interest per annum. Therefore, on the basis of a 3-percent coupon, this obviously means a 25 percent increase in interest charges—with nothing in the way of jobs or services to show for it.

2. Bonds totaling approximately $500,000,000, still unissued, have been authorized by vote of the people of this State. Assuming an average life of 20 years for these bonds, an additional three-fourths of 1 percent in interest charges could obviously add as much as $75,000,000 to the ultimate cost of completing this financing.

3. But that is not the only serious aspect. Under the proposed statute the States "theoretically" would be given reciprocal powers to tax Federal securities. While such "reciprocity," even as concerns the States, is largely one-sided, the very theory of reciprocity would not extend to municipalities. To them the increased interest costs would mean a dead loss. Are they prepared to assume this burden?

4. It is estimated that by doing away with the tax exemption on State and municipal bonds the Federal Government's revenue will ultimately be increased thereby by approximately $300,000,000 annually. Even assuming the correctness of this estimate, nobody ever collects money without somebody else paying its equivalent. Who pays it in this instance? The ordinary local taxpayer upon whose property the tax differential would have to be assessed by the issuing municipality.

5. Some authorities argue that taxing public bonds would force capital to venture more into private enterprise. But it is difficult to conceive how the mere addition of a tax handicap to the one type of security would of itself reduce the risks inherent in the other. Certainly such a tax would not alter the relative merits of existing credits.

Speaking generally, no proposal in modern times has been so fraught with danger to the American fiscal system or to the fundamental American principle of decentralized powers. Certainly, no legislator, either State or Federal, who can truly claim to represent the constituents who elected him, can possibly favor a statute of such serious consequences.

If you agree with these observations, I hope you will make it your business personally to convey your views in no uncertain terms to the United States

Senators from New York State and to the Representative in Congress from your district.

Very truly yours,

MORRIS S. TREMAINE,
Comptroller of New York State.

The views expressed in the foregoing communication are based upon conclusions reached after mature and careful consideration and upon long years of experience in the practical business of public finance.

I might add, there is no spot in the world where you can get greater knowledge of the fiscal affairs of a municipality than you can get in the comptroller's office.

In formulating them I have had available studies made by the able staff of fiscal experts in the comptroller's office at Albany, and also an excellent and most competent report prepared at my request, and after months of research and study, by Dr. Harley L. Lutz, Professor of Public Finance at Princeton University.

On behalf of the State of New York, I would like to submit Dr. Lutz's report to the committee, with the request that it be made a part of the record of your proceedings. The report is, quite naturally, rather voluminous, but I believe we have sufficient copies to satisfy the requirements of the committee.

In the letter of transmittal, which you will find at the beginning of the report, Dr. Lutz has summarized his principal conclusions, both fiscal and economic. I suggest that the Senators will find it a convenient summary of the points made in the report itself.

However, we have asked Dr. Lutz to come here today, and, if it please the committee, I request that at this point he be given an opportunity to place before you a brief review of his studies and methods of analysis, and an explanation of the conclusions to which those studies led him.

May I say in introducing him to the committee that Dr. Lutz has been professor of economics at Obelin College and Stanford University, and professor of public finance at Princeton since 1928. He was an advisor to the Washington Tax Investigating Commission of 1922, a member of the Commission on Financial Advisors to Chile in 1925, and to Poland in 1936. He was an advisor also to the Tax Investigation Commission in Utah in 1929, and the director of the New Jersey Tax Survey Commission of 1930. He is the author of many works on economics and taxation, including the standard text on public finance, and was the president of the National Tax Association in 1928.

It is now my pleasure to introduce Dr. Lutz.

Mr. TOBIN. May we ask that the economic report of Dr. Lutz be printed as a part of the record of this committee?

It is very important, we believe, and it is a very voluminous study of this matter.

The CHAIRMAN. It is voluminous. I have read the letter of transmittal, and scanned through the rest of the report. I rather think we can put it in, but I want to leave the matter in abeyance until I have an opportunity to consult with the rest of the members of the committee before we decide.

(Subsequently the fiscal and economic study prepared by Dr. Lutz for Hon. Morris Tremaine, Comptroller of the State of New York, and submitted to the committee by the comptroller was ordered incorporated in the record.)

THE FISCAL AND ECONOMIC ASPECTS OF THE TAXATION OF PUBLIC SECURITIES

A REPORT PREPARED BY HARLEY L. LUTZ, PROFESSOR OF PUBLIC FINANCE, PRINCETON UNIVERSITY, FOR THE COMPTROLLER OF THE STATE OF NEW YORK, MORRIS S. TREMAINE

Submitted to the Congress of the United States by the Comptroller of the State of New York

THE FISCAL AND ECONOMIC ASPECTS OF THE TAXATION OF PUBLIC SECURITIES

LETTER OF TRANSMITTAL

Hon. MORRIS S. TREMAINE,
Comptroller of the State of New York,
Albany, N. Y.

SIR: I transmit herewith a study, made at your request, of the fiscal and economic aspects of the taxation of public securities. As the report is somewhat voluminous—necessarily so because of the ramifications of the subject—the principal findings and conclusions are listed below for your convenience:

1. Federal taxation of State and local securities would cost the States and municipalities a minimum of $113,000,000 annually in increased interest cost (p. 114). The Federal revenue from such taxes is estimated at an average of $95,000,000 (p. 122).

2. If taxation of securities now exempt were made reciprocal, so that the States could tax interest on Federal securities, the conclusion is reached that the States could not collect, on the 1937 basis, more than $17,000,000 from that source (p. 123), as against their loss of $113,000,000 above.

3. State taxation of Federal interest would cost the Federal Government $30,000,000 annually in higher interest costs (p. 125), as compared with a yield to the States of $17,000,000 from that source.

4. Furthermore, if the net gain to the States from a tax on Federal interest is $17,000,000, and if the loss to the States from higher interest on their own debt is $113,000,000, then reciprocity would cost the States a net loss of $96,000,000 (p. 125).

5. The Federal Government would not fare much better. If it should derive the averaged figure of $95,000,000 from the taxation of State interest, and also gain $109,000,000 by removing the exemption of Federal securities (p. 138), the total apparent Federal gain would be $204,000,000. But offset against this would be a Federal loss of $157,000,000 in added interest cost due to Federal taxation of Federal interest (p. 139), plus a Federal loss of $30,000,000 due to State tax on Federal interest (par. 3 above), a total Federal loss of $187,000,000, wiping out nearly all the total apparent gain of $204,000,000 (p. 140).

6. Thus, using the averaged figures, the proposal now recommended to the Special Committee of the Senate on Taxation of Governmental Securities by the Treasury Department, would indicate a combined net loss to the Federal and State Governments of $79,000,000—the excess of the net loss to the States over the net gain to the Federal Government (p. 140).

7. The Treasury's assertions that wealthy people are loading their estates with exempt securities are erroneous. For example, capital stocks of corporations exceed by several times the total amount of exempt securities in estates of every size. A study of 3,044 estates over $1,000,000, with a total gross value of $10,583,000,000, showed only $1,038,000,000, or less than one-tenth, in State and local bonds (p. 117). If we include in the study 105,499 smaller estates aggregating $21,900,000,000 we find $793,320,000 in State and local exempt bonds in such estates, or 3.61 percent of the total. Taking both the large and small estates the ratio of the State and local exempt securities to the total gross estate is only 5.63 percent (p. 117).

8. The relative number of people in the high surtax groups who could benefit from the ownership of tax-exempt securities is small. It is only above an income level of approximately $60,000 a year that the investor of tax-free securities begins to gain on the basis of the average yield spread in 1938 (p. 142). Yet all the evidence (par. 7 above) is that the persons who could benefit from the ownership of tax-free securities have not sought complete escape in the haven of the tax exempts. Ownership of these securities in large estates is definitely incidental to their corporate and other private investments (p. 117).

9. The proposal would bring about gross discrimination as between the States because of the uneven distribution of Federal security holdings (p. 126). In only a few States is the revenue from State income taxes substantial in amount (p. 127), and 12 States have no income tax at all (p. 129). For example, in Delaware the income tax yields 0.40 percent of total taxes whereas in Arkansas, it yields but 1.09 percent, in Alabama 1.56 percent and in South Dakota, 0.30 percent—but again, in New York, it yields 10.83 percent. There was no income tax in 1937 in 12 States: Florida, Illinois, Indiana, Maine, Michigan, Nebraska, Nevada, New Jersey, Rhode Island, Texas, Washington, and Wyoming (p. 127).

The unfairness and discrimination as between States is also illustrated by the fact that in Louisiana the added cost of interest would amount to 99.4 percent of the total income taxes collected, while in Wisconsin it would be 8.2 percent (p. 128).

10. Any revision of the existing doctrines of intergovernmental immunities should take into consideration the loss which the States now suffer as a result of Federal real-estate holdings. There are many hundreds of millions of dollars' worth of Federal property located in the States, the exemption of which from taxation causes the States and the municipalities a huge tax loss. The States and the cities might properly resent the exclusion of this factor from consideration in any reciprocity scheme.

11. I have mentioned the gross discrimination that such a proposal would entail as between the individual States. The effect upon the cities would involve not only discrimination, but irreparable fiscal injury. Municipal debts total nearly 10 billion as compared with State debts of only a little over 3 billion. Local governmental subdivisions of the United States are limited, in their exercise of the taxing power, very largely to the property tax. A perpetual struggle goes on, between the cities and their taxpayers, on the one hand, and between the cities and their respective States, on the other. The taxpayers resist increase of the property tax, and the cities are pressing for larger participation in the State-collected taxes.

The extent to which the cities might share in any income-tax receipts is problematical. In a few States the yield of the income tax is shared, in others it is a State revenue. In all of the latter States such gains as would be realized from the State tax on Federal interest would go into the State treasury, while the onerous task of meeting the higher costs caused by the Federal tax on local bond interest would fall, without even the hope of compensating advantages, on the local governing bodies (p. 131). The amount by which the property tax levy would have been increased, under the conditions prevailing in 1936, would have ranged from 42 cents per $1,000 in Milwaukee to $2.10 per $1,000 in Detroit (p. 132). It should be noted, furthermore, and as a typical example of the "piling up" of these discriminations, that Detroit would have no opportunity of recovering any part of this increase through the taxation of Federal interest, since Michigan has no State income tax.

12. You will be interested in the effect upon your own State. The increased interest cost on the State debt of New York would be $4,412,000 and upon municipal and local debts $22,833,000, a total increased burden on New York State and its municipalities of $27,245,000. This burden is so large that it would of course require additional taxation to make up the loss. As a matter of fact, the Federal tax would cause an increase of New York's debt cost greater than the increase caused by additional borrowing during the period of 5 years from 1932 to 1937. What I mean by this is that in 1932 the State of New York and its municipalities paid $145,743,000 in interest charges and in 1937, $169,066,000, a gain of $23,323,000 in interest charges, due mainly to relief and other expenses caused by current economic conditions. But the increased cost resulting from Federal taxation would be $27,245,000, which is approximately $4,000,000 in excess of the heavy increase in interest cost during the 5-year period mentioned. The additional interest burden on the taxpayers of New York State alone would be equal to the amount which all of the States combined could expect to receive from the taxation of Federal securities (p. 134).

13. Taking a neighboring State, New Jersey, we find that New Jersey was able to reduce its State and local interest charges by approximately $1,000,000 between 1932 and 1937, thus improving its financial condition to that extent. This saving would be wiped out more than seven times by an increased interest burden of $7,970,000, resulting from Federal taxation. To be more specific, New Jersey's total interest, including both State and municipalities, was $54,870,000 in 1932 and $53,769,000 in 1937, a saving of $1,101,000, but the additional interest caused

by Federal taxation would be $7,970,000. The increased burden on New Jersey taxpayers would be almost half the amount, namely, $17,000,000, which all States combined might expect to derive from the taxation of Federal interest (p. 134).

14. As to particular cities, New York City alone would have an added interest cost of $14,293,000 as compared with the sum of $10,697,000 which it received in 1937 as its share of the State personal income taxes and as compared with $5,675,000 as its share of the State business corporation tax. Buffalo would pay $870,000 in additional interest as compared with $620,000 as its share of the State personal income tax and as compared with $528,700 as its share of the State business corporation tax. Rochester would pay $463,700 in additional interest as compared with $401,000 and $365,000. Syracuse would pay $243,200 as compared with $238,000 and $143,500. Yonkers would pay $215,400 as compared with $203,000 and $35,400. Albany would pay $234,100 as compared with $149,900 and $87,300. Utica would pay $252,700 as compared with $84,100 and $34,500 (p. 133).

15. As to cities in New Jersey, which has no income tax, the increased interest cost would be as follows: Newark, $885,000; Jersey City, $553,000; Paterson, $197,000; Trenton, $126,000; Camden, $168,000; Elizabeth, $105,000 (p. 133).

16. The immediate effect of the Treasury proposals on the refunding programs of the States and municipalities is critical. Thus Detroit has outstanding $118,000,000 of bonds at 4 percent or higher, of which $74,000,000 bear 4½ percent or higher. The city has $80,000,000 additional which it called for payment in recent years out of the proceeds of refunding bonds sold at much lower interest rate, and as a result the city is saving $1,142,000 in interest annually. It desires to continue this refunding which promises to save an additional $1,000,000 each year. The entire State debt of Michigan matures in 1944, some of which must be refunded because certain bonds held in the sinking fund will not have matured at that time, and these bonds cannot be sold except at a heavy discount (p. 162).

17. The gross discrimination as between States is further shown by the fact that the majority of the States, and also of the important counties and cities, have very little prospect of fiscal advantage from the suggested waiver of Federal tax immunity. The total State revenue from the taxation of Federal interest would be small in any case and it may vanish entirely under the social-security program. Such revenue as may be collected will be heavily concentrated in the few States in which the bulk of the individuals and corporations that own these bonds are domiciled. Elsewhere, the interest cost will greatly exceed the possible revenue gain (p. 127).

18. In view of the importance of the housing problem in New York State, recently forwarded by the amendment to the State constitution, you will, I am sure, find helpful the analysis on pages 163–164, which indicates that the advancement of low-cost housing will be seriously interfered with if the policy of tax immunity is to be altered. Here again the loss to the States and cities is obvious for the States will have to find the money for additional subsidies or grants.

19. The figures shown in this report, and those submitted to the special Senate committee by Mr. John W. Hanes, Under Secretary of the Treasury, relative to the ownership distribution of Federal and local securities, are in substantial agreement (p. 179). My estimate of total Federal revenue, namely, $204,000,000, is within Mr. Hanes' estimates, which covered the wide range of $179,000,000 to $337,000,000. My estimate of $113,000,000 as the increased interest cost to the States and their subdivisions is to be compared with Mr. Hanes' upper estimate of $105,000,000. Our figures are far apart as to the effect of the removal of tax exemption upon the cost of the Federal debt, but Mr. Hanes' estimate of this cost does not reconcile with his statement that interest rates, except on the Treasury bills and certificates, will be increased by one-fourth to one-half of 1 percent. My estimate of the increased Federal interest cost allowed no effect on the floating debt, and assumed interest rate increases of one-fifth of 1 percent for the short-term debt, and of one-half of 1 percent for the long-term debt. Mr. Hanes' acceptance of one-half of 1 percent for the effect of a Federal tax on the interest cost of long-term debt gives support to my assumption that the average increase for State and local debt will be 60 points, or three-fifths of 1 percent.

20. It is said that the immunity of State and local bonds must be ended to curb extravagance. To be effective as a curb on local borrowing, the tax must materially increase interest costs. But Mr. Hanes' statement before the special Senate committee emphasizes the view that only a moderate increase of interest rates will occur. The main purposes of State and local borrowing have been the provision of services required by the people or by the forces of social change. While a real, or an apparent, necessity for such improvements exists, the borrowing will go on, regardless of the interest costs. Taxation will simply add to the burden of debt financing (pp. 158–164).

21. The claim that tax immunity diverts funds from enterprise also ignores the facts. Virtually the whole of the existing State and local debt was created before 1930, a period in which there was no lack of enterprise capital. Total State and local debt increased by less than $150,000,000 from 1932 to 1937. If enterprise capital has been lacking during these years, one must look elsewhere for the reasons (pp. 153–164).

22. As an economic and social question, the taxation or exemption of public securities is not altogether one of so-called tax justice. The Congress has authorized other exceptions to strict progression, in the belief that both the public interest and the public revenue would be better served by such a policy. Examples of these exceptions are the treatment of long-term capital gains and the deductions for charitable contributions. The exemption of public securities involves also a balancing of different interests, including those of the public revenue. The effects of removing this exemption cannot be confined to the few individuals most directly involved in the issue of tax justice and progressive taxation. These effects extend to all taxpayers, who stand to lose more, through higher taxes for debt interest, than the Federal Government will gain in additional tax revenue (pp. 145–147).

23. The estimates of large revenue loss from tax immunity are a product of wishful thinking. They rest on the assumptions, (1) that a huge proportion of the public securities are owned by wealthy individuals, and (2) that these persons will continue to hold large amounts of such securities after the tax is imposed. The first assumption is not supported by any available data (pars. 7 and 8 above). While no prediction can be made as to the second of these assumptions, the present ownership distribution of the partially exempt Federal securities does not support it. It is quite likely, therefore, that the actual revenue loss would prove to be of small proportions. The present interest saving, caused by the holdings of individuals with large incomes, is a real saving to all other taxpayers (pp. 148, 149).

You will note that for the purposes of this study I have considered it necessary to make the following basic assumptions—they are simply the establishment of a fixed basis upon which to formulate estimates:

(*a*) Any change of tax policy to be made will apply only to future debt issues.

(*b*) Existing tax rates and other taxation provisions are used in formulating estimates.

(*c*) The calculations are made on the assumption that substantially the present level of national income will prevail.

(*d*) A refunding issue is deemed to be a new issue, and hence taxable, although it may merely replace an issue that was originally exempt. Furthermore, it is assumed that the volume of State and National obligations will remain constant, and that they will not be further withdrawn from the Federal and State taxing powers.

These assumptions mean also that it will require more than 40 years at the normal rate of refunding for the effects of the tax proposals to become fully realized. During the interim period the results will gradually approach the final calculations herein submitted.

The assumptions made ((*a*), (*b*), (*c*), and (*d*) above) will also be affected by a variety of unpredictable circumstances. If, for example, the Government were to put a larger proportion of its issues into the social-security fund, naturally, the States could collect no revenues from such holdings; and since it is the policy of the Federal Government to put more and more securities into the social-security fund, the promise of additional revenues to the States might turn out to be illusory: It would certainly be less than I have shown in my calculations. In using these figures, therefore, you will bear in mind that they are calculated upon assumptions that may turn out to be very much worse for the States in their realisation than the figures would otherwise show.

I have summarized here only some of the more important conclusions to which the study brings me.

Respectfully submitted.

HARLEY L. LUTZ.

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INTRODUCTION

This report deals with some of the fiscal and economic aspects of the question of tax exemption as it relates to the income from Federal, State, and local securities. The whole field of tax exemption and tax immunity is a wide one, and the practices that have developed within it, in the application of Federal, State, and local taxation, are so diverse and involved as to produce an exceedingly complicated situation. The aspect of the subject to be considered in this report has received more attention than any other, yet the consequences of some other phases of tax immunity under the Federal-State relationship are of fully as much importance as are those which involve the income tax. They include such things as Federal taxation of State trust-fund revenues, municipal utility revenues, and other receipts. All Federal property is immune from local taxation. To the cities, which depend so heavily upon the property tax, this fact looms larger than any privilege of taxing the interest received by those who may hold Federal bonds. Federal vehicles need not carry State motor-vehicle licenses, which means that the license tax is not paid. Nor is the State gasoline tax paid on the fuel which is used to operate these Federal vehicles. In the sales-tax States, sales that are made directly to the Federal Government or its agencies are not taxable. In short, the problem of intergovernmental tax relationship is large and complicated.

Moreover, it is, in many respects, an integral problem. While certain phases of the subject can be isolated for discussion, as is done here, it is by no means certain that an acceptable solution can thus be found. On the surface it may seem to be a simple matter to dispose of the immunity of State and local bond interest from Federal income tax. But in fact, even this one aspect of intergovernmental immunity raises complex and far-reaching issues. Such a tax change would imply a termination of the rule of State immunity from Federal taxation. But if this rule of State immunity goes, does it follow that the other part of the same rule, namely, Federal immunity from State taxation, may also go? The principal argument for holding that the particular taxation change which is desired, from the Federal point of view, namely the extension of the Federal income tax, can be accomplished by statute is that the reciprocal immunity rule is a court-made doctrine, and hence it can be unmade by the same court that created it.

A very important issue is at once raised. If State immunity is gone, or if it can be ended by court decision, what will happen to Federal immunity, which is a part of the same rule? If the termination of the reciprocal immunity doctrine can be evidenced by Federal taxation of State and local bond interest, will it follow that the cities are to be free to tax post offices and other Federal property under nondiscriminatory property taxes? If not, why not? Can the doctrine of intergovernmental tax immunity be both discarded and retained at the same time?

The Department of Justice suggests that Federal immunity must remain, but offers as a palliative a congressional permission to the States to tax Federal securities. It is immediately obvious that such a permission could be withdrawn, and indeed might have to be withdrawn, by a subsequent Congress.

The latest phase of the discussion was opened by the President's message of April 25, 1938. This message was followed, a few months later, by a study published by the Department of Justice, and by a statistical summary of the volume and ownership of public-debt obligations prepared by the Treasury Department.[1] While the above

[1] The Immunity Rule and the Sixteenth Amendment, by the Department of Justice, and Securities Exempt From the Federal Income Tax as of June 30, 1937, by the Treasury Department. For convenience and brevity of citation, these documents are identified here as the White Book and the Treasury Gray Book, respectively.

documents have suggested that the States may also tax Federal interest, it is clear that the discussion of intergovernmental immunity which they present is limited to the Federal viewpoint, and it is further limited to the income tax, as if this were the only matter involved in the doctrine of reciprocal immunity. It is necessary to point out that if the major premise is valid, then many other things may follow than a mere extension of the Federal and State income taxes. This major premise is that reciprocal immunity is gone but gone only far enough to permit Federal taxation of the States. But if reciprocal immunity is gone, then far-reaching questions at once emerge with respect to the tax jurisdiction of the States. It is not simply a question of making a sufficient crack in the wall of intergovernmental immunity to let the Federal income tax through. It is a question of tearing the wall down.

No one has considered, as yet, all that can happen under either Federal or State taxation, if the immunity wall is entirely destroyed. No attempt is made in this report to deal with all of the issues that are obviously involved. The objective here is that of examining the various aspects of the taxation of the income from public securities, from the standpoint of the States and cities as well as from that of the Federal Government. Every effort has been made to weigh, carefully and objectively, the gains and losses that may be experienced on both sides.

The subject of tax exemption was actively discussed in the early twenties, but the problem was believed to be limited to the narrow field of the tax-exempt security. An amendment was discussed but it was not submitted to the States. This amendment aimed simply at a reciprocal waiver of tax immunity as regards the taxation of public-debt interest. It did not contemplate complete elimination of intergovernmental immunity. One of the principal influences in support of the amendment was said to be the private utility interests, which saw in the tax immunity of State and local bonds a factor that would be favorable to the spread of municipal ownership.[3]

It would be possible today to narrow the subject to the same field of public-debt interest, if action were to be taken through an amendment. But if action is to be sought by statute, on the only ground that would support statutory action, namely that the immunity rule is gone, then it is hardly possible for the developments to be restricted to the field of income taxation. A Pandora's box of taxation possibilities and taxation mischief will be opened.

Exemption or immunity.—It seems proper to raise, at the outset, a question of terminology. The expression, "tax-exempt securities" has been applied without discrimination to all debt issues which have not been subjected to the Federal income tax. The question is whether or not it is strictly correct and proper to speak of State and local securities as being "exempt" from the Federal taxing power. Exemption means a deliberate remission of a tax which government has power to impose. It is an act of grace, an indulgence which is granted for such purposes, and which is motivated by such considerations, as may have seemed adequate and proper. A government cannot exempt those things or persons which it has no power to tax. They are immune from its taxing authority. Despite the position taken by the Department of Justice, it is impossible to concede that the immunity rule has entirely disappeared. In any event, it has been settled constitutional doctrine for a long time that the States, and their instrumentalities and agencies, are immune from the Federal taxing power.[4] Until this matter has been definitely determined, it is still true that the State and local debt obligations are immune, rather than exempt, from the Federal taxing power.

This technically correct terminology has been used in the following report, except for occasional lapse into popular usage in order to avoid misunderstanding. It is fundamental to recognize that with respect to Federal taxation and the whole field of public securities there are two distinct problems, namely the exemption of Federal bond interest from Federal income tax, and the immunity of State and local bond interest from that tax. One is a matter of statute, while the other involves a constitutional issue that goes to the heart of the Federal system of government.

In one respect this difference is vital, for it means that the two problems must be dealt with in different ways. That is, the exemption of Federal interest from Federal tax is a matter of statutory change, whereas the removal of the immunity hitherto accorded to State and local bond interest is a matter of constitutional change. In another respect, however, the two issues have a common denominator, which makes it possible to discuss them together. That common denominator,

[3] O. O. Hardy, Tax-Exempt Securities and the Surtax (1926), pp. 27-29.

[4] *Pollock v. Farmers Loan and Trust Co.*, 157 U. S. 429; 158 U. S. 601; *National Life Insurance Co. v. United States*, 277 U. S. 508, and other decisions.

with which this report deals, is the comparative gains and losses, fiscal, economic and political, that are involved.

Plan of the report.—The report is divided into two main sections. Part I presents such evidence and argument as it has been possible to assemble relative to the comparative revenue gains and losses that can be traced to the exemption and the taxation policies, respectively. Part II will review some of the pertinent considerations of a broader and more general economic character that may have influenced, in part, the development of the existing policy and that should be held in mind in arriving at a judgment respecting the change, if any, to be made in this policy.

Some basic assumptions.—The calculations and estimates that are offered in this report are based on certain assumptions as to legislative policy and general economic conditions. This is in no sense an attempt to forecast either policy or conditions, but simply the establishment of a fixed basis upon which to formulate estimates. In the degree to which legislative policy or general economic conditions should vary from those now prevailing, corresponding modifications of the calculated results of a given taxation policy would be implied. The principal assumptions made are the following:

(1) Any change of tax policy that may be applied to the interest on public debt obligations, whether by statute or by constitutional amendment, will affect only those obligations to be issued in future. In other words, retroactive taxation is not dealt with here as among the practical possibilities.[4]

(2) Estimates of future effects involve a projection of existing tax rates and other statutory provisions, into the future.

(3) The estimates indicate results which might be expected, in future, from the operation of the existing tax law upon a national income of substantially the present volume.

(4) Since the interest on future debt issues only is to be taxed, all estimates and calculations purport to show the ultimate effects, after there may have come into existence a mass of debt obligations equivalent to that now outstanding. This does not imply, necessarily, an indefinite continuance of State or Federal indebtedness for precisely the same purposes or services, in the performance of which the existing debt was incurred. It merely assumes that eventually, whether for renewal of wasted assets or in the performance of other services requiring the provision of improvements, a volume of new debt issues may emerge in an amount equivalent to the present debt. Should this not be the case, then all estimates of revenue and increased interest cost would be modified correspondingly.

(5) Under a normal process of retiring presently outstanding debt and creating new debt for the same, or for new and additional public purposes, it would require upwards of 40 years to transform a mass of debt equivalent to the existing total into taxable securities. This process will be considerably hastened, however, by the refunding which must occur with respect to a large proportion of the Federal debt, and to a smaller, yet substantial proportion of the local debt. It is necessary to clear up very definitely the tax status of refunding issues.

In some directions it has been contended that the refunded debt is merely an extension of both the obligations and the privileges attaching to the original issue. An example is the question of legality for savings-bank investment. If the original issue had this privilege, it might be deemed to be carried over to the refunding issue.

Does the tax exemption or immunity of existing issues likewise carry over into such refunding as may occur? In this report it has been assumed that the tax privilege will not be extended forward, but there has been no declaration of policy on this point. The subject is of sufficient importance to require express clarification in advance of any promulgation of policy.

PART I. THE FISCAL ASPECTS OF TAX IMMUNITY AND TAX EXEMPTION

Summary

The fiscal aspects of the taxation of public-debt interest are considered in part I. The following optional approaches are distinguished:

(1) Federal taxation of State and local bond interest, with no reciprocal waiver of Federal immunity from State taxation, and with continued exemption of Federal interest from Federal taxation.

[4] It should be noted, however, that in the recent study made by the Department of Justice (supra, p. 100) it is held that the Federal Government has the power to tax outstanding State and local securities as well as those to be issued in future. The study recommends, as a matter of policy, that the suggested legislation be limited to future issues.

(2) Reciprocity of taxation between Federal and State Governments, but with continued exemption of Federal interest from Federal taxation.

(3) Elimination of the exemptions now granted to Federal securities under Federal law. This option might be applied alone, as the only step to be taken, or it might be applied in combination with options (1) and (2). Federal taxation of Federal interest is a matter of statutory change only. It can be done at any time, and it involves no constitutional questions, such as are involved in any change of the relationship between Federal and State Governments.

Option I. *Federal taxation of State and local interest.*

(1) The States would get no revenue, as they are assumed to have no privilege of taxing Federal interest (p. 100).

(2) The effect of the Federal tax on State and local bond interest would be to cause some change or adjustment of yield basis on these securities. Agreement is quite general on this point, but opinions differ as to the amount of the yield basis change.

A canvass of expert opinion, consideration of existing market differentials, and a deduction as to what would happen if investors succeeded in shifting the tax to the debtor governments lead to the conclusion that an average yield basis of adjustment of 60 points would result in the case of the long-term State and local debt. For the short-term debt, the corresponding adjustment would be 20 points. This means that a city which might borrow today on a 3-percent basis, would probably have to pay about 3.6 percent after the tax became fully effective (pp. 109–111).

On this basis, the cost of carrying a volume of State and local debt as large as that now outstanding would be $113,000,000 above the present interest cost of that debt. If the yield basis adjustment should prove to be 75 points, the cost to the States and cities would be approximately $140,000,000, and if it should be as much as 100 points, or 1 percent additional, the cost would be $185,000,000 (p. 113).

(3) The Federal revenue from the taxation of State and local bond interest would depend, first, upon the amount of interest paid, and second, upon its distribution among categories of investors. As of 1937, the total State, local, and territorial interest was $803,000,000. The distribution of this amount is estimated to have been as follows:

	Amount in millions
Public trust and investment funds	$180.0
Institutions exempt from Federal tax	60.6
Total excluded from Federal tax	240.6
Taxable corporations	200.0
Individuals with net income under $5,000	25.0
Individuals (including partnerships, estates, and trusts) with net income of $5,000 and over	337.4
Total taxable State and local interest	562.4
Total State and local interest	803.0

(4) On the basis of the corporate record of the 10 years, 1927 to 1936, inclusive, it is estimated that as an average, only 60 percent of the State and local interest received by corporations will be received by those corporations having net income. Hence, only 60 percent of the amount imputed to the corporations would be taxable. Assuming this interest to be taxed at 16⅔ percent, the Federal revenue would be $19,800,000 (p. 120).

(5) The State and local interest received by individuals with net incomes under $5,000 would be mingled with the vast pool of income received by these taxpayers, and subject to such deductions and allowances as they are permitted to make. In 1936 the highest effective rate of income tax paid by persons in these net income groups was 0.84 percent. (The effective rate is obtained by dividing the taxable income into the amount of tax paid.) This part of the tax would therefore be $210,000 (p. 120).

The tax on that part of the State and local interest imputed to the net incomes of $5,000 and over will depend upon the ownership distribution of these securities after the tax is imposed. Reports of such interest received are made, for information, with income-tax returns, but the reporting is incomplete since no tax liability is involved.

A special examination was made of all estate tax returns filed in the period 1926 to 1936, inclusive. The details are shown in appendix D, and a summary is given in table V, on page 117. This analysis disclosed:

(1) A tendency for the proportion of gross estate invested in State and local bonds to rise as the estate became larger. But there was no uniform tendency toward such concentration, as many large estates evidently held quite small amounts of such securities.

(2) A definite preference for corporate bonds over all classes of tax exempt bonds in the net estates below $1,000,000, and a definite preponderance of corporate bonds over Federal bonds in all estates.

(3) The capital stocks of corporations exceeded, several times, the amounts of all classes of tax-exempt bonds in estates of every size. There are individual exceptions, but the general picture obtained from the estate tax data does not reveal any strong or marked tendency for wealthy individuals, taken as a whole, to convert their entire estates into tax-exempt securities.

No satisfactory evidence exists to indicate just what the ownership distribution pattern for State and local bonds would be after their subjection to Federal income tax. The two clues to this distribution that were used in estimating the tax yield were:

(*a*) The existing distribution of partially exempt Federal securities, and (*b*) the present distribution of taxable corporate bonds as revealed by the estate tax data. The detailed calculations of tax yield are given in appendix G. A composite result of these calculations, including the estimated Federal tax on the additional State and local interest to be paid as a result of the tax, produces an estimated Federal revenue of about $120,000,000 (p. 121).

This estimate is probably too high, for it rests on the assumption that all State interest not otherwise accounted for in the available surveys is received by the individuals with net incomes of $5,000 and over. An estimate made in 1937 by Dr. Roswell Magill, then Under Secretary of the Treasury, placed the probable revenue at $70,000,000. An average of these results would be a Federal revenue of $95,000,000, which is to be set against the estimated increase of State and local interest cost of $113,000,000 (pp. 121, 122).

Option II. *Reciprocal State and Federal taxation of bond interest.*—This option introduces State taxation of Federal interest, with its revenue results for the States and its probable effect on Federal interest costs.

(1) Not all of the States have income taxes, and the rates used by those which do apply this tax are quite variable. It is estimated that $839,980,000 of Federal interest was paid, in 1937, to taxable investors, the remainder going to public investment funds and to exempted institutional investors. The corporations are estimated to have received $565,000,000 of which 60 percent is assumed to be taxable, through being reported by corporations having net income. The remainder of the taxable Federal interest was received by individuals.

Using a typical State corporation tax rate of 4 percent, and a typical State personal income-tax rate of 5 percent, the maximum State revenue as of 1937 would have been some $27,000,000. But the 12 States which had no income tax would reduce the actual receipts by about 25 percent, on the basis of 1936 personal income taxes paid to the Federal Government. Hence, after allowing for the graduated rates, it is concluded that the States could not have collected more than $17,000,000 under 1937 conditions (p. 123).

(2) The privilege of taxing Federal interest would operate very unequally among the States. In only a few States is the present State income tax a revenue measure of any importance. These States, such as New York, Massachusetts, Wisconsin, and Delaware, might expect the larger share of State gain from the taxation of Federal interest. None of the States with substantial State and local debt would have a chance of obtaining additional revenue in anything like the proportionate increase of their debt costs under the Federal tax. The 12 States with no income tax have almost 30 percent of total gross State and local debt. In these States alone the increased debt cost caused by the Federal tax on State interest would be some $31,000,000 annually, or almost double the amount that all of the income-tax States could expect to gain from the taxation of Federal interest.

(3) The position of the cities would be even worse, for they must now carry the bulk of the debt costs. Further, they would be obliged, in most of the States, to press for a sharing of any revenue that might be obtained from a State income tax on Federal interest. On the basis of 1936 figures, as published by the Bureau of the Census, the following changes of local tax rates would be necessary to absorb the increased interest costs, assuming an average yield basis adjustment of 60 points for the debt:

City	Tax rate per $1,000, 1936	Tax rate adjusted to include increased interest cost	City	Tax rate per $1,000, 1936	Tax rate adjusted to include increased interest cost
New York City, N. Y.	$27.14	$28.01	Camden, N. J.	$43.15	$44.38
Chicago, Ill.	95.20	96.93	Seattle, Wash.	52.54	54.82
Detroit, Mich.	27.90	30.00	Houston, Tex.	44.62	45.88
San Francisco, Calif.	26.76	27.68	Tampa, Fla.	53.15	54.46
Newark, N. J.	38.18	39.15			

(4) The States must also consider the possible effect of the social security program, which as originally enacted contemplated a huge old-age reserve fund, invested in Federal securities. Unless this program is radically altered, as now recommended by the Advisory Council, it may be that within 40 years virtually the whole of the Federal debt will be beyond the reach of their income tax, through acquisition for the old-age fund. The cities must consider the effect of removal of tax immunity upon their plans for extending municipal ownership of local utilities. Finally, if the extension of tax jurisdiction is made by statute, as the Department of Justice proposes, there can be no guaranty that a future Congress will not revoke the waiver of Federal immunity (p. 124).

(5) The effect of the State taxation of Federal interest is assumed to produce an average-yield-basis adjustment of some 7 points, which would result in an increased interest cost to the Federal Government of some $30,000,000 annually. The financial result of reciprocal waiver of tax immunity would therefore be, under present conditions, a State revenue gain of some $17,000,000, as against a Federal loss, in higher interest costs, of some $30,000,000 (pp. 123, 125).

Option III. *Elimination of Federal exemption for Federal interest, with or without reciprocal waiver of intergovernmental tax immunity.*

The results of Federal taxation of Federal interest, calculated by the methods which were used in the case of the Federal taxation of State interest, would be a probable revenue of $109,000,000. The effect of complete Federal taxation of all Federal debt interest would be an estimated yield basis change of 50 points in the case of the long-term debt, and of 10 points in the case of the short-term debt. On this basis, the increased interest cost would be some $157,000,000 (pp. 138, 139).

Summary of the net results under the three options

[All figures in millions of dollars]

STATES

Gain: Tax on Federal interest	17
Loss: Federal tax on interest	113
Net loss to States	96

FEDERAL GOVERNMENT

Gains:		Loss:	
Tax on State interest:		State tax on interest	30
Estimate (*a*)	120	Federal tax on interest	157
Estimate (*b*)	70	Total Federal loss	187
Estimate (*c*)	95		
Tax on Federal interest	109		
Total Federal gain:			
Estimate (*a*)	229		
Estimate (*b*)	179		
Estimate (*c*)	204		

Net gain (or loss) to Federal Government:	
Estimate (*a*) gain	42
Estimate (*b*) loss	8
Estimate (*c*) gain	17

Balance of State and Federal gain or loss:

Under estimate (*a*), a combined net loss of 54 (excess of net State loss over net Federal gain).

Under estimate (*b*), a combined net loss of 104 (sum of State and Federal net losses).

Under estimate (*c*), a combined net loss of 70 (excess of State net loss over Federal net gain).

The outlook for net fiscal advantage from any sort of change in the tax-exemption or tax-immunity situation is not particularly attractive. One reason for this result is the amount of State, and of Federal interest respectively, that is received by agencies and institutions excluded from income tax. Otherwise, there would doubtless be at least a fairly even balance between revenue gain and increased interest loss.

Some such result is what might be expected from a deductive approach, if it be assumed that those who were made subject to a tax, from which they had formerly been immune, would make an effort to shift it. The continuing presence of a field of tax exemption, over against the remainder of the investment field for which there is no exemption, creates a differential in favor of the tax-free investments. Withdrawal of the tax preference would tend to wipe out this differential, not by causing the acceptable rate of investment return in the taxable field to drop to the level which had proved to be acceptable in the tax-free field, but by the reverse process of causing the yield basis in the formerly exempt field to rise to a level approximating that in the investment area which had always been subjected to taxation. If it be assumed that such part of the yield differential as may be ascribed to the tax-exemption privilege be eliminated as a result of the tax, then there would be a tendency for the revenue and the increased interest cost to equal each other. Those who believe that the effect of a steeply progressive tax would be to produce far greater revenue than the increased interest cost must first show that a large proportion of the public securities will remain in the large incomes and be taxed there at very heavy rates.

The Fiscal Aspects of Tax Immunity and Tax Exemption

The strictly fiscal side of the tax-exemption policy is the question of gain or loss, in dollars and cents, for the various governmental units which may be involved in the particular policy adopted. The gain would be expressed as the additional revenue to be secured through an extension of taxing jurisdiction to the income received as interest on any class of public securities, and the loss would be expressed as the additional amount that would be required to be paid as interest on this class of public securities after that interest had been subjected to income taxation. The extent of these gains and losses would of course depend upon the specific form of the tax program under which the existing exemptions or immunities were to be modified or removed.

No definite pronouncement or program has as yet been promulgated relative to the specific nature of the taxation changes that may be advocated. There are, however, the following options in making these changes:

I. Federal taxation of State and local bond interest with no reciprocal privilege to the States for the taxation of Federal bond interest. That is, an extension of the Federal taxing power with no reciprocal extension of the States' taxing power.

II. Reciprocity of taxation between the Federal Government and the States, with respect to bond interest but with continued exemption of part, or all, of the interest on Federal obligations from Federal taxation.

III. Elimination of the exemption now granted to Federal securities under Federal tax laws. This option could be applied in two ways, namely, (*a*) it could be combined with options I and II, thereby eliminating completely all tax exemptions and immunities, or (*b*) it could be introduced, by simple statutory revision, as the only change to be made in the existing policy. In this form it would avoid all problems of a constitutional nature with respect to the field of Federal or State taxing jurisdiction.

Each of these optional ways of dealing with the problem of tax exemption involves the question of relative gains and costs. The procedure to be followed here is that of presenting the data relative to gains and costs under the above options, in the order in which they are given above.

Option I. The Fiscal Effects of Federal Taxation of State and Local Bond Interest, With No Reciprocal State Taxation of Federal Interest

In discussing this option there is no need to inquire whether it is one that would be seriously considered by Congress, or one that might prove acceptable to the country as a solution of the problem It is a logically possible alternative and

for this reason must be examined. Such examination is not waste effort, even if there be no thought of applying it, for the data to be presented here will have their place in the complete canvass of possibilities.

1. *The effect on State revenues.*—Under the first option, the States would evidently obtain no additional revenues. It is assumed that they would not have the privilege of taxing the interest on Federal bonds, and the revenue gain will inure solely to the Federal Treasury.

2. *The effect on State and local interest costs.*—The first effect of the subjection of income from State and local bonds to Federal income taxation would be to diminish the net return or net yield which investors would realize from this form of investment. What would be the effect of this diminution of net income, after taxes, upon the general investment attitude toward these bonds?

This attitude has always been a composite of various influences. The resultant of these forces has led to some degree of preference for public as against private debt issues, and therefore to some difference in their respective price and yield bases. Such differentials existed prior to the development of heavily graduated income taxes, although it was never a fixed or constant spread. Even in those days the private bonds were theoretically taxable under State property taxes, but the laxness of administration was such as to afford virtual exemption of these bonds, and of all other intangible property, in most jurisdictions. For practical purposes, therefore, the great bulk of the pre-war private debt obligations were as effectively exempt from taxation as were the public debt issues. The fact that the price and yield spread between public and private bonds could, and at times did, virtually disappear before the beginning of vigorous income tax administration would indicate that the elements of security and marketability, which were supposed to make the public debt issues a superior investment, were not at all times sufficiently important to be a decisive factor in the market valuations.

The relative unimportance of the nontax factors prior to the income tax is shown in the comparison of bond yields given in table I.[1]

TABLE I.—*Comparison of railroad and municipal bond bases prices*

Issues	1902	1912	1922
	Percent	*Percent*	*Percent*
All railroad bonds	3.75	4.26	6.97
First-grade railroad bonds	3.25	4.00	5.64
The Bond Buyer's Index (20 municipals)	3.18	4.01	5.00

From this comparison it appears that prior to the introduction of the Federal income tax the difference between the general market estimate of the investment value of the first-grade railroad bonds and the first-grade municipal bonds was negligible. In fact, it disappeared entirely in 1912. By 1922, however, a definite differential had emerged. The growing financial difficulty of the railroads would invalidate any further use of railroad bonds as reliable index of the relative investment value of taxable and exempt debt issues, but it is significant that in the years when there was general confidence in the ability of the railroads to support their debt, and when there was no complication in the form of comparative taxation, the investment rating of good public and good private issues was so close together.

The yield spread or differential between public and private securities has been more persistent, however, since the development of progressive income taxation. The concurrent circulation in the same market of securities that are taxable and of other securities that are exempt would tend to create an investment preference for the latter. It is true that the private securities which are taxable and the public securities which are exempt are not alike in other respects. If it had always been true that these differences, which have always existed, had always accounted for a definite differential in favor of the public debt issues, then it would be more difficult to establish that the differential which has become so marked under the income tax is attributable in any material degree to the effect of the tax.

There is fairly general agreement that the effect of a tax on the income from a class of public securities which the investing public has for long regarded as nontaxable would be an adjustment of price and yield basis that would represent an effort by the investors to recover part, or all, of the tax from the debtor governments. Insofar as this effort is successful, the result is that the debtor govern-

[1] Data supplied by The Bond Buyer (New York City).

ments will pay more for the funds which they borrow, after the tax and as a consequence of its imposition, than they would have paid had there been no tax.

The adjustment could occur in one or other of two ways. The first would be an increase of the coupon rates of interest demanded before the taxable bonds could be sold at the prices which they commanded prior to the tax. The other would be a downward adjustment of the market price, assuming no change in the level of coupon rates. The revision of price would mean shrinkage or disappearance of the premium in cases where a premium would be paid for the tax-exempt bond, or sale at a discount instead of at par in cases where par could have been obtained for the exempt security. However, the adjustment might occur, it would mean, in effect, an increased cost of borrowing, expressed either in direct form through a rise of coupon interest rates, or in indirect form as a decline in price which would compel larger nominal borrowings in order to realize a given amount, and thus to larger aggregates of interest to be paid.

Many competent persons have said that removal of the tax-exemption privilege would increase the cost of borrowing. In 1922 Mr. Andrew Mellon testified as follows:[6]

"Mr. GARNER. The farm loan bonds would have to absorb this tax in an increased rate of interest, would they not?

"Mr. MELLON. They would have to pay an increased rate of interest, undoubtedly. They always would. It might be a lesser or a greater amount of rate of interest and ight not be higher than the rates now prevailing but it would be somewhat higher if this exemption were not allowed than with the exemption, naturally, and so would all Government issues.[7]

"Mr. FREAR. Does not this question arise then, Mr. Secretary, that there is an assumption that the 3½-percent tax-free security of the Government can be put out at par? Is that true?

"Mr. MELLON. Probably.

"Mr. FREAR. That is true today, that the Government can issue 3½-percent tax-free securities?

"Mr. MELLON. Perhaps. Now to sell a security at par that is not tax free the Government would have to pay a rate of interest today of more than 4 percent of course.

"Mr. CRISP. More than what?

"Mr. MELLON. More than 4 percent. I suppose it would depend upon the length of time they would have to run, but it would be somewhere from 4½ to perhaps 5 percent, depending on the length of time they would run."[8]

Secretary Mellon also submitted a letter from the Government actuary, Mr. J. S. McCoy, which gave certain estimates of the amounts of tax-exempt securities then outstanding, and concluded as follows:

"There is little doubt that under these conditions the future investor in what are now tax-exempt securities would demand that they have a higher rate of interest or be sold at a discount sufficient at least to meet the tax."[9]

In his pioneer study of the subject of tax-exempt securities, published in 1926, Dr. C. O. Hardy used a yield differential of 84 points to measure the saving in interest for the States through the immunity of State and local bonds.[10] The committee on taxation of the Chamber of Commerce of the State of New York, in a report dated January 24, 1923, estimated that Federal bonds issued on a wholly taxable basis would reflect an increase of 1 percent in the rate of interest.[11] Mr. L. H. Parker, chief of staff of the Joint Committee on Internal Revenue Taxation, recently testified as follows:[12]

"It is the opinion of this office that if the income tax were applied in full to all future issues of these bonds the increased interest cost would nearly offset the additional revenue secured."

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[6] Cf. Hearings before the Committee on Ways and Means on Tax-Exempt Securities, January 16, 18, 19, and March 7, 1922.

[7] Ibid., p. 15.

[8] Ibid., p. 29.

[9] Ibid., p. 21. See also, The Federal Chart Book, issued under the direction of the Industrial Committee of the National Resources Committee, January 1938, p. 64. A chart showing the differential in yield between Federal and private bonds is explained as follows:

"The yields on long-term U. S. Government bonds are always lower than the yield on corporate bonds, as a result of the tax-exemption features, lower risks and other special features attaching to Treasury securities."

[10] C. O. Hardy, Tax-Exempt Securities and the Surtax (1926), p. 96.

[11] Chamber of Commerce of the State of New York, Monthly Bulletin, vol. 14, No. 7 (1923).

[12] Hearings before the subcommittee of the Committee on the Judiciary, United States Senate, June 24, 1937.

Finally, a report of an address by Senator Pat Harrison, of Mississippi, Chairman of the Senate Finance Committee, before the Economic Club of Detroit, contains the following: [13]

"The Senator discussed the liberalization of estate taxes and the legislation recommended by the President, proposing the taxation of income derived from future issues of Federal, State, and local securities, as well as ending the present tax exemption on Government salaries of all kinds—Federal, State, and local. He said:

" 'The effect of taxing the income from Federal, State, or local issues will inevitably make them less attractive to the investor, and therefore make it more difficult for the respective governments to market their obligations. So, while it is difficult to prophesy what the Congress will do, it is my opinion that in the end an opportunity may be afforded the States and the people to pass on this question by constitutional amendment.' "

(*a*) *The measurement of increased interest cost.*—While there is fairly general agreement that the imposition of a tax on the interest to be derived from public-debt obligations that are now nontaxable would be to shift the tax, wholly or in part, to the debtor government, there is less certainty as to how much yield adjustment will actually occur. This aspect of the problem is complicated by various matters, such as the rate at which the taxable securities are to appear, the prevailing prospects of profitable return in industry, the stability and prospects for the current outstanding supply of taxable private bonds, the financial strength and security of the debtor government, the imminence of general price inflation or of further currency devaluation, and so on. It is also complicated by the attitude of investors in different categories, and particularly by the policy to be adopted by the individuals with large incomes. No definite predictions are possible as to the investment behavior, after the tax becomes effective, of any of these groups.

Since investors have not been confronted, as yet, with the problem of comparing securities which are identical except for the tax privilege, it becomes necessary to rely on opinions and on inferential evidence as guides to the probable effect of the removal of tax immunity upon the yield basis of these securities.[14]

When the amendment to abolish tax-exempt securities was under consideration, in 1922, much testimony was taken before congressional committees, and the subject was discussed at some length on the floor of each House. Apropos of the estimate as to the effect of a Federal tax on the cost of State and local debt, the following passage from the remarks of the Honorable John N. Garner, then a member of the House of Representatives, is of interest: [15]

"The advocates of this amendment talk about it from an economic standpoint. I can demonstrate, and the estimator for the Treasury Department will bear it out, that for every dollar's worth of taxes you get in the way of taxation by virtue of this amendment the interest paid will be four times that tax. The people pay this in the long run, whether the bonds are issued by the Federal Government, the State government, the county, the school district, the road district, the irrigation district, the drainage district, or by whatever other political subdivision. The people pay for it after all. Why do you want to adopt a system by which for every dollar you get into the Treasury of the United States $4 will have to be paid by the public in the form of added interest?"

Some direct opinion evidence has been collected in the course of this investigation. A list of representative State and municipal issues, with fairly long maturity, was sent to a group of investment houses that specialize in such securities, with the request that they express a considered opinion as to the effect of Federal taxation on the yield basis of these securities. The replies were solicited and given under a pledge of confidence as to the names of those reporting, but an average of the estimates was an increase of 0.614 points in yield rates.[16] That is, on the average, it was believed that the maintenance of the existing price structure for these bonds would require an average increase of 0.61 points in the interest rates.

[13] Quoted from the Washington Star, December 19, 1938.

[14] Some evidence has come in relative to the effects of other taxes. From Ohio it is reported that the State income tax of 5 percent caused as much as 50 points change in the yield basis of bonds issued by Ohio cities and school districts. Data submitted by W. E. Kershner, Secretary of the Ohio State Teachers' Retirement System, Columbus, Ohio. In Massachusetts, different State issues, some subject to the State income tax and others exempt, sold in the local markets on a yield differential of 25 to 30 points. Data submitted by George W. Rice, city treasurer of Springfield, Mass.

[15] Congressional Record, vol. 64, p. 712, 67th Cong., 4th sess., Dec. 19, 1922.

[16] See appendix A for a list of the securities, with the estimates of change in yield basis for each. The firms making these estimates are "keyed" to preserve anonymity.

As indicated above, the corresponding adjustment in prices instead of in the yield basis would involve the same relative increase in cost for the debtor units.[17]

A similar canvass was made of several large insurance companies, as being representative of the whole group of institutional investors in State and municipal securities. The average of insurance company estimates of the necessary increase of yield basis was 0.682.

While these figures constitute opinion evidence only, they deserve consideration in view of the sources from which they come. Yet they may be criticized as inconclusive, notwithstanding the peculiar qualifications which may be possessed by those who responded to the questionnaire. Another and more objective test is supplied by the bond market itself. Since this market has not as yet been called upon to register its reaction to the effect of Federal taxation, it becomes necessary to infer, from the spread which it now establishes between the nontaxable securities and the highest grade taxable securities, what might be expected to happen if the immunity were to be removed.

In order to test the market appraisal of the differential between exempt and taxable bonds, two comparisons have been made. One is the relation between the Bond Buyer index for 11 cities selected for high credit standing and Moody's index of triple A corporate bonds. The other is the relation between the yield bases of high-grade municipal bonds and A1+ corporate bonds, compiled by Standard Statistics, Inc. These comparisons are presented here in graphic form and the yield data used in preparing the charts are given in appendices B and C, respectively. Chart I, which shows the relative trend of yield bases according to the Moody and Bond Buyer indices, begins with 1928. To it has been added, also, the Treasury Department's calculation of the yield basis of Government bonds with a maturity longer than 8 years. Chart II, which shows the Standard Statistics yield estimates, covers the years 1936–38.

In reading these tables and the charts which present the same material in graphic form, the significant thing to observe is the spread between the yield basis of the taxable and the exempt securities. This is the important factor in measuring the effect on interest rates, when a shift is made from exempt to taxable status, or vice versa. The yield trends rise and fall with general economic conditions and the relative abnormality of the period from August 1931 to July 1934, is clearly brought out. Disregarding such extremes, it is significant that the spread is fairly stable, whether interest rates in general are falling or rising. There is a somewhat wider spread after 1934, as the present level of surtax rates came into effect, than there was in the late twenties, when the maximum surtax rate was much lower than it now is.

The effect of the Federal tax on State interest costs may be measured in still another way. This is by estimating the change of yield basis that would be caused by an attempt of investors to shift the tax. Actually, all of the above estimates represent the opinions of various groups as to just how much shifting can be accomplished. A measure of this shifting can be sought in the tax rates themselves. In part II below evidence is given to show that the income level at which the investor begins to gain through the purchase of nontaxable securities is [redacted] and $55,000 to $60,000, if the yield differential be such as prevailed during 1938.[18] The surtax rate at the $55,000 level is 35 percent. This rate is also approximately the average or effective tax rate which would have been levied on all State interest deemed, in later sections of this report, to have been received in 1937 by individuals with net incomes of $5,000 and over. The average or effective rate is obtained by dividing the total taxable income into the total tax. On the other hand, corporations are liable to pay a tax rate of only 16½ percent, assuming that they are able to comply with all of the conditions for deductions set out in the Revenue Act of 1938.

According to the data given in appendix B, the average yield of high-grade municipal bonds in 1938 was 2.60 percent. That is, $100 so invested would produce annual income of $2.60. Therefore, if individual investors who would have to pay, on the average, 35 percent of this income as a Federal income tax, should seek to shift this tax through a corresponding yield-basis adjustment, it would require a yield change of 35 percent of $2.60, or some 91 points in the yield cost. For the corporations, the change would be 16½ percent of $2.60 or 41 points. An average of these extremes would be 66 points, which almost

[17] A questionnaire was circulated among State and local finance officers in the autumn of 1938. These officials are in direct contact with the bond market and with the firms which buy their respective issues. Their opinion, as expressed in replies to the questionnaire, indicated a belief that the effect of a Federal tax would be to cause a yield adjustment of even greater degree than the figures given in the text.

[18] Infra, p. 147.

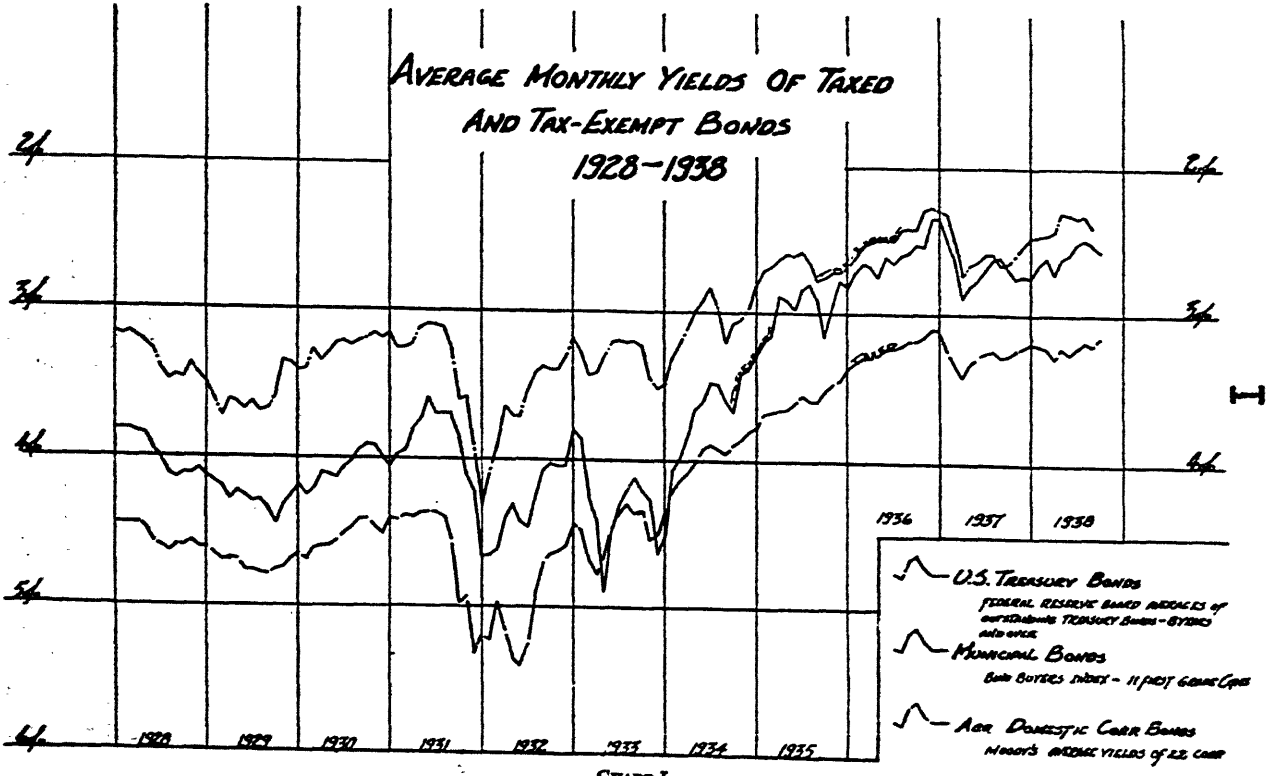
AVERAGE MONTHLY YIELDS OF TAXED AND TAX-EXEMPT BONDS 1928–1938
2%
3%
4%
5%
6%
1928
1929
1930
1931
1932
1933
1934
1935
1936
1937
1938
U.S. TREASURY BONDS
FEDERAL RESERVE BOARD AVERAGES OF OUTSTANDING TREASURY BONDS – BY YIELDS
MUNICIPAL BONDS
BOND BUYER'S INDEX – 11 HIGH GRADE CITIES
AAA DOMESTIC CORP. BONDS
MOODY'S AVERAGE YIELDS OF AAA CORP.

CHART I.

coincides with the average of the insurance-company estimates of the effect of the Federal tax.[18]

Combining the evidence from these various sources, it is suggested that a fair measure of the difference in interest cost for the States and their subdivisions, after the subjection of the interest on their bonds to Federal income taxation, would be an increase of 60 points in the interest rate. If they are able to borrow today on an average basis of 3 percent this would mean an average basis of 3.60 percent after the removal of tax exemption.

It should be noted that the foregoing estimate of yield differential refers to the adjustment to be expected in the price of the best State and municipal issues. A greater relative adjustment might occur in the case of the weaker issues. If the change of yield basis for the best municipal obligations were to be only 60 points, the corresponding change for the poorer grades of these securities

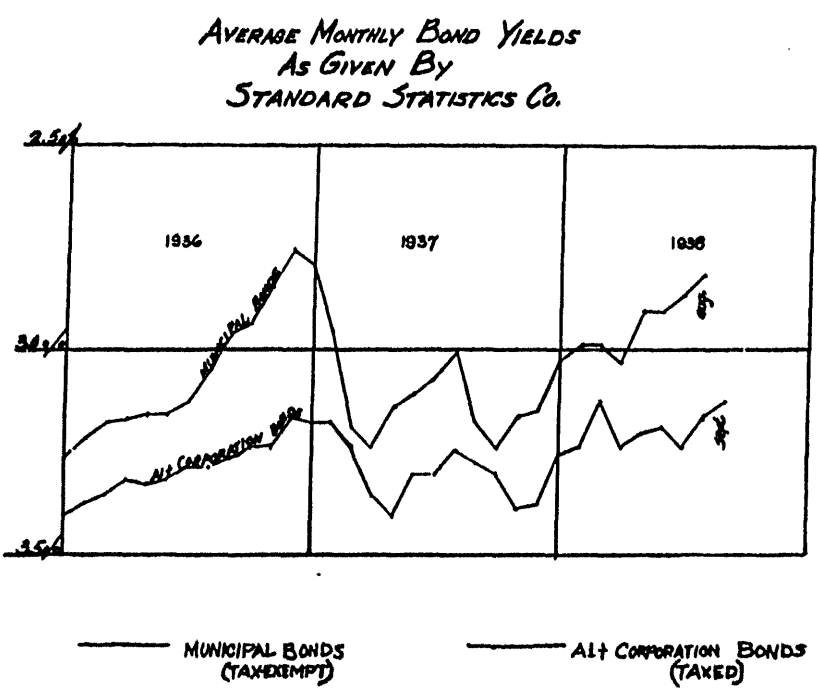

CHART II.

could be as much as 75 or 100 points. In this comparison the quality of a State or local debt obligation depends on such things as the total debt of the debtor community, the past record of debt payment, the total tax rate, the record of tax collections, the economic and business conditions and prospects, the purpose of the loan, and other factors which would indicate ability to maintain interest and principal payments without delay or interruption.

(i) *The effect of the tax on the yield of short-term debt.*—Some question may arise as to the effect of the tax on the yield of short-term debt. This paper consists largely of tax anticipation notes and other temporary loans, and it is likely to be held mainly by the banks and other financial institutions. Consequently the amount of tax to be paid is more accurately to be measured by the rates at which corporations are liable than by those to which individual investors are subject. While the cost of temporary borrowing depends on current market conditions, the rates tend to be somewhat easier than for the long-term loans. In the case of the Federal short maturity obligations, the interest rate in some cases is virtually nil. The States and cities do not use the Treasury bill, however, and they would not

[18] Supra, p. 109.

in any case get as favorable rates as the Federal Treasury obtains on short-term loans. One clue to the cost of these loans for the larger cities is shown by the average interest cost of floating debt for the cities with a population of 100,000 and over. In 1936 this average interest cost was 2.2 percent, figured on the nominal or par value of the floating dept.[10] If the corporate purchasers of the floating debt paper of States and cities were to attempt a shifting of their income tax on this paper, it would require a yield basis adjustment of some 33 points. For the purpose of the present computations, however, an average yield adjustment of 20 points is taken in the case of the short-term loans.

(*b*) *The effect of Federal taxation on the cost of State and local borrowing.*—In the preceding section it was concluded that a fair measure of the change of yield base caused by the Federal tax would be 60 points for long-term debt and 20 points for short-term debt. These figures are not intended as maxima, for a reservation was made with respect to the lower grade issues. In the absence of any adequate classification of State and local debt issues which would indicate the relative proportion that might suffer greater yield basis change, it is necessary to proceed as if the figures to be used here were proper averages for the whole of that debt. The results to be obtained may therefore understate the effect of the Federal tax, since they may not provide, in fact, proper allowance for the market reaction to the lower grades of State and local securities.

Before proceeding with the calculations, it may be well to recall an assumption laid down in the introduction, to the effect that the results to be shown here are intended to describe the ultimate rather than the immediate effects of any change of taxation policy.

(*i*) *State and local debt as of June 30, 1937.*—The first step in computing the effect of the Federal tax on the cost of State and local borrowing is to ascertain the volume of State and local debt. In table II there is presented a summary of State and local interest-bearing debt as of June 30, 1937.[11]

TABLE II.—*State and local interest-bearing debt, 1937*

[Millions of dollars]

Division	Long term	Short term	Total
States	3,084.0	157.6	3,241.6
Counties	2,237.8	85.5	2,323.3
Municipalities	9,485.1	483.9	9,969.0
School districts	1,723.8	140.5	1,864.3
Other districts	1,751.7	23.0	1,754.7
Total	18,262.4	890.5	19,152.9

This mass of debt is composed of a huge variety of issues, with widely differing terms such as coupon rates, maturities, call and redemption provisions, and so on. The prices at which these various issues sell also vary widely, being governed both by such local factors as the volume of tax collections, the ratio of total debt to borrowing capacity, and the previous debt record of the debtor community; and also by such general or external factors as the coupon rate, the size of the issue and the condition of the general money market at the time.

Each issue represented in this aggregate had its price when issued and this will be true of the new issues that will replace old ones. It would be inaccurate to say that every new State or local bond issue, after the removal of tax immunity, will require a uniform mark-up of the interest rate in order to sell at the prices for which equivalent issues may have sold prior to the changed taxation policy. Some of these issues will require a greater mark-up than others. As indicated above, since this range cannot be forecast, the only available procedure for estimating the total additional interest cost is by applying a reasonable average to the whole volume of indebtedness outstanding.

(*ii*) *Increased interest cost on the basis of 60 points increase for long-term debt.*—The calculation of increased interest cost is made by applying the assumed change of yield basis to the gross amount of debt outstanding. It may be objected that not all of this debt is held by investors who would be subject to Federal income tax. But the fact is that as each State or local issue is offered, those investors who

[10] *Cf.* Bureau of the Census, Financial Statistics of Cities, 1936, tables 16 and 22.
[11] From The Treasury Gray Book, p. 52.

would not be liable to income tax, such as mutual savings banks and university endowments, could not afford to ignore the possible effects of the tax. These effects could safely be ignored only if there were positive certainty that the exempted institution were to hold the particular issue to maturity. Otherwise, at any future time when the bonds had to be sold for cash, they would be subject to a material discount because of the fact that the interest thereon was subject to Federal income tax.

Moreover, these exemptions are simply a matter of statute, and while their presence in the income tax law from the beginning creates a presumption that the practice will be continued, it does not constitute a guarantee. The exempted institutions could not afford, therefore, to buy taxable securities on a basis other than that established by the general market price structure.

Using the State and local debt figures given in the preceding table II, the following effects of the Federal tax are obtained, assuming 60 points increase for long-term debt and 20 points increase for short-term debt:

TABLE III.—*Estimated increase in the cost of State, local, and Territorial debt, resulting from the removal of tax immunity, on the basis of an average increase of 60 points in long-term yield basis*

Debtor division	Increased interest cost of long-term debt, assuming 60 points increase	Increased interest cost of short-term debt, assuming 20 points increase	Total estimated increase of interest cost
State	$19,504,000	$315,000	$19,819,000
County	13,427,000	171,000	13,598,000
City	56,911,000	978,000	57,889,000
School	10,343,000	281,000	10,624,000
Other divisions	10,390,000	46,000	10,436,000
Territorial	882,000	9,000	891,000
Total	111,457,000	1,800,000	113,257,000

The result of subjecting the interest on State and local debt to Federal taxation, as measured by the assumed change of yield basis, would be an annual increase of some $113,000,000 in the cost of that debt. The yield adjustment assumed, namely 60 points for the long-term debt, is lower than that which competent persons in close touch with the bond market have suggested. If the actual effect of the Federal tax on the long-term debt yield basis should be as much as 70 points, the total increase in cost, still assuming only 20 points increase for the short-term debt, would be $130,600,000. On the basis of an adjustment of 75 points, the cost to the States would be $139,900,000, and on the basis of 100 points, or 1 percent, the cost would be $185,900,000 in round figures.

Summary of assumptions and findings as to the effect of a Federal income tax on the cost of State and local borrowing.—On the basis of the following assumptions:

(1) That the removal of tax immunity from State and local bond interest will result in a rise of at least 20 points in the cost of short-term debt and of at least 60 points in the cost of long-term debt, both increases being expressed in the effective interest rates;

(2) That eventually there will be subject to the tax the interest on a volume of debt substantially the equivalent of the present outstanding State and local debt;

It is found that the increase of interest cost to the States and their subdivisions would be of the magnitude of $113,000,000 annually. If the yield adjustment for long-term debt should be as much as 75 points, the additional interest cost would be $139,900,000, and if that adjustment should be as high as 100 points, the total added cost would be $185,900,000, in round figures.

Under the option that is here considered, namely, that there is to be no waiver of Federal tax immunity, the States would derive no additional revenue as an offset to the increased cost of supporting their own debt.

3. Federal revenue from the taxation of interest on State and local bonds.—In approaching the problem of the Federal revenue yield from the taxation of State and local securities, it is necessary to discover, so far as may be possible, where these securities are now held. Beyond doubt, their subjection to Federal income tax will cause some shifts of ownership and there can be no certainty that the existing pattern of ownership distribution would be duplicated in the future. Entirely

too little is known, even of the present ownership distribution, to permit more than a rough guess with regard to it and with regard, therefore, to the Federal tax yield.

(a) *Types of ownership.*—Three general types or classes of ownership of State and local bonds may be distinguished. These are: (1) Public trust, sinking, and investment funds; (2) institutional investors now exempted from Federal income tax by statutory provision; and (3) corporations and individuals subject to income tax.

Both the first and the second of the above general classes of investors are now excluded from the scope of the income tax. The State and local trust and sinking funds have heretofore been deemed to be immune from the Federal taxing power, but there is, in the minds of some Federal officials, some doubt as to whether this immunity can longer be sustained. In the present report it has been assumed that the Federal tax jurisdiction does not extend far enough to compel States and cities to pay income tax on the revenues received by their own investment funds. Were this conceded it would be logically necessary to go farther and include also the State and local revenues of every description, including the tax revenues.[23]

It is also assumed here that the current Federal policy with respect to exempted institutional investors will be maintained, although it has been indicated above that no guaranty of such continued exemption has been, or can be, given.

The first step, therefore, in a calculation of the Federal revenue from the taxation of State and local bond interest is to trace the ownership of these bonds, in order to make an allocation of the interest paid thereon to those investors who are now subject to the Federal income tax.

(b) *State and Federal bonds held by governmental funds and agencies.*—The amounts of State, local, and Territorial securities held by governmental funds and agencies as of June 30, 1937, were as follows:[24]

TABLE IV. *Amounts of State, local, and Territorial bonds held by governmental funds and agencies, as of June 30, 1937*

Type of ownership:	
State and local sinking funds	$1,491,000,000
State and local trust funds	2,279,000,000
Federal agencies	528,000,000
Territorial sinking funds	26,000,000
Total	4,324,000,000

(c) *State and local bonds held by exempted institutions.*—No complete record is available to show the amount of State and local bonds held by exempted institutions. The Treasury Gray Book contains a compilation of the recorded or reported tax-exempt holdings of selected categories of investors, which indicated the following:[24]

Category of investor	Date	Amount of State and local bonds reported
Mutual savings banks	June 30, 1937	$831,000,000
Foundations	Dec. 31, 1936	64,000,000

This compilation revealed, further, that as of December 31, 1936, the fraternal benefit societies held $550,000,000 of tax-exempt securities, and that the universities held $25,000,000. The fraternal benefit societies apparently invest chiefly in State and local bonds, for Dr. Carl H. Chatters estimated their holdings of

[23] The assertions recently made by the Department of Justice as to the extent of the Federal power under a literal interpretation of the sixteenth amendment would seem to include the taxation of State and local revenues. Cf. the following: "* * * the court in *Helvering* v. *Gerhardt* seems to have rejected the reciprocal test of tax immunity and returned to Chief Justice Marshall's understanding that the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated, and supreme, taxing power of the central Government." Op. cit., p. 9.

In a recent address, the Chief Counsel of the Bureau of Internal Revenue asserted "the power of the National Government to tax the people and the institutions of the State." Address of John Philip Wenchel before the Investment Bankers of America, October 26, 1938.

[24] Treasury Gray Book, pp. 56, 63.

[24] Op. cit., p. 113.

these securities as of December 31, 1932, at $500,000,000.[35] In this report it is assumed that as of December 31, 1937, the fraternal benefit society holdings of State and local bonds were $550,000,000, and that the university holdings were $13,000,000. Hence the aggregate holdings of exempted institutions in 1937 may be put at $1,458,000,000.

(d) *State and local bonds held by investors subject to Federal income tax.*—It is obvious that investors subject to income tax must own all of the outstanding State and local bonds which cannot be assigned to either of the above immune or exempted categories of owners. The taxable investors are either corporations or individuals, including in the latter category estates, trusts, and the members of partnerships.

(i) *Holdings of corporations.*—The Treasury Gray Book contains figures relative to the tax-exempt holdings of corporations subject to the income tax. The amounts, and the dates as of which the reports were made, are as follows:[36]

Category of investor	Date	Amount of State and local bonds held
Banks (excluding mutual savings)	June 30, 1937	$2,769,000,000
Life insurance companies	Dec. 31, 1937	1,424,000,000
Other insurance companies	Dec. 31, 1936	322,000,000
Nonfinance corporations	Dec. 31, 1935	359,000,000

(ii) *Holdings of individuals.*—Individuals are asked to report, for information, their holdings of tax-exempt securities together with the interest received thereon, in making income-tax returns. Since no tax liability is involved in the case of State and local bonds, the amounts of both the principal held and the interest received are undoubtedly incomplete. This conclusion is supported by the fact that after allocating all reported or recorded holdings, there remains to be accounted for a much larger total of State and local debt obligations than is reported by those who make income-tax returns.[37]

From the standpoint of the proposed changes of taxation policy, chief interest attaches to the holdings of wealthy individuals. The motive of tax reduction is supposed to be stronger for this group than in the case of other classes of investors. Banks and insurance companies are interested in this feature of any public security which they may own or buy, but they are also concerned with some other features, such as relatively assured yield, supported by the taxing power, comparative steadiness of price, ready marketability and so on. They are influenced also by the need of diversification of holdings and in some cases by statutory limitations or requirements as to the type of asset held.

(iii) *Distribution of State and local bonds as revealed by the Federal estate-tax returns.*—One indication of ownership distribution for the tax-exempt securities is provided by the Federal estate-tax returns. The annual Statistics of Income presents a digest of the estate-tax returns filed, by calendar years. The net estates are classified into size groups, and the investments which make up the gross estate are shown, as aggregates, for all estates within each group.

An examination of the year by year returns will reveal some curious variations. Some large estates evidently hold substantial amounts of tax-exempt securities, while others, equally large, contain little or no such property. There certainly is no absolutely uniform degree of concentration of tax-exempt securities into the large property holdings. In order to obtain a larger sample than is afforded by the estate-tax returns for any one year, all of the returns reported upon in the annual Statistics of Income for the years 1926 to 1936, both inclusive, were thrown together. A summary of the results is presented in table V.

[35] *Cf.* Municipal Debt Defaults, Their Prevention and Adjustment, edited by Carl H. Chatters (1933), p. 2. Public Administration Service Bulletin, No. 33.

[36] Op. cit., p. 113.

[37] For the tabulation of the reports of tax-exempt principal and interest for 1936, *Cf.* Statistics of Income, 1936, p. 30.

TABLE V.—*Summary of certain investment items in estate tax returns filed in the calendar years 1927–37, inclusive* [1]

[Dollar amounts in thousands]

Number or amounts	All estates to $1,000,000 of net estate	Ratio to gross estate	All estates above $1,000,000 of net estate	Ratio to gross estate	Total	
Number of returns	105,499		3,044		108,493	
					Amount	Ratio
Federal bonds:						
Wholly exempt	$229,860	1.05	$389,997	3.69	$619,857	1.90
Partially exempt	540,236	2.46	119,056	1.12	659,292	2.03
State and local bonds	793,320	3.61	1,038,708	9.81	1,832,028	5.63
All other bonds	1,858,558	8.46	507,976	4.80	2,366,534	7.27
Corporation capital stocks	7,940,261	36.14	5,845,438	55.23	13,785,699	42.35
Total gross estate [2]	21,969,492		10,583,354		32,552,846	

[1] A more detailed exhibit of the results obtained from the analysis of the estate-tax returns is presented in appendix D.

[2] The total gross estate includes all other items, such as real estate, mortgages, cash, etc. It does not represent the total of the holdings given in the table.

The summarizing of estate-tax returns over a period of years is useful for the purpose of obtaining a more adequate sample, but the results should be used with a certain caution. The total wealth, or total assets, which have passed through the records of the Federal estate tax collectors in this 11-year period probably constitute from one-fifth to one-fourth of the aggregate that will be dealt with and levied upon by these collectors in the course of a human generation. The data therefore represent a sufficiently large proportion of the total to be reasonably typical of the character and the distribution of wealth ownership in general. While the discussion of the material at this point relates simply to the ownership of State and local bonds, as evidenced by the estate-tax returns, the analysis as a whole extended to the ownership of Federal bonds also and the results are included, for convenience, in this table.

The broad cross-section of security ownership which is presented in table V would probably afford a certain aid and comfort to either side of the argument regarding the ownership distribution of State and municipal bonds, and also of Federal securities. It reveals, for instance, that there is some concentration of these bonds into the larger estates. The distribution according to the estate brackets used by the Statistical Section of the Income Tax Unit in compiling the returns shows a fairly regular progression in the amount of such holdings as the size of the estate increases, but with some curious variations which are to be explained by the limited number of estates in those particular size groups.[38] More than half of the total of State and local securities held by the estates which have been accounted for to the Federal Government in this 11-year period have been in the estates of more than $1,000,000. But, on the other hand, the concentration of these securities into the large estates is not excessive. All of the estates reported upon during the 11-year period held an aggregate of $1,832,028,000 of State and local bonds. Of this total, $793,320,000, or 43.3 percent, were in estates with a net value of $1,000,000 or less, while $1,038,708,000, or 56.7 percent, were in estates with a net value above $1,000,000. The State and local bonds have likewise constituted a larger proportion of gross estate in the case of the large than of the small estates. For all estates over $1,000,000 this ratio was 9.81 percent, as against 3.81 percent for the small estates and an average ratio of 5.63 percent for all estates. But there are many, no doubt, who will learn with some surprise that less than 10 percent, on the average, of the investments of estates above $1,000,000 was in State and local bonds. The public has been inclined to accept the view that the very rich people own very little else, since the very rich are supposed to be more concerned about escaping the Federal income tax than with anything else.

[38] *Cf.* appendix D.

Some of the peculiar variations in the distribution of State and local bonds, as shown in appendix D, should be mentioned. There were, in all, 87 estates of $10,000,000 and over, in the 11-year period. The average ratio of State and local bonds to gross estate in these largest fortunes was only 7.55 percent, and in the 13 estates between $9,000,000 and $10,000,000, the average ratio was only 3.20 percent. But in the 25 estates between $8,000,000 and $9,000,000 the ratio was 21.30 percent, and in the 32 estates of the next smaller bracket, $7,000,000 to $8,000,000, the ratio was 15.03 percent. It dropped to 6.76 percent, however, for the 50 estates with gross value of $6,000,000 to $7,000,000.

The final column of table V is particularly significant, however, as a general or over-all picture of the relative holdings of State and Federal securities by all classes of investors. The wholly exempt Federal bonds were only 1.9 percent of total gross estates, while the partially exempt Federal bonds were 2.03 percent of gross estates. State and local bonds constituted 5.63 percent of all gross estates. All classes of exempt securities together comprised 9.56 percent, but it should be particularly noted that the holdings of taxable bonds represented, in all, 7.27 percent of gross estates, or almost as large a proportion as all of the classes of exempt securities combined.

In all of these high brackets, the total number of cases, even over an 11-year period, is rather small, and it can always be said that the sample is not representative. But the absolute number of such cases in the entire community is not large, and a sample of any size would, perforce, include them all. The evidence seems to indicate that there simply is no fixed rule of investment, and above all it demonstrates that the large estates do not include, without exception, a huge block of State and local securities held for the purpose of large-scale tax avoidance.

It is also brought out by the estate-tax data that the State and local bonds have been a larger proportion of gross estates than Federal bonds, at least so far as the mortality experience of this 11-year period goes. The partially exempt Federal bonds have been a very small factor in the large estates, for obvious reasons. While the wholly exempt Federal bonds are of somewhat greater relative importance in the large than in the small estates, it is rather surprising that they do not constitute as large a share, anywhere, as the State and local bonds. This may be ascribed in part to the comparatively limited supply.

(*e*) *Relation of nontaxable and taxable securities in estate tax returns.*—The analysis extended also to the bonds and stocks of corporations, and some interesting points are brought out. The proportion of all estates, whether large or small, that has been invested in the capital stocks of corporations is very much larger than that invested in any kind of tax-exempt security. Also, for the large estates in the aggregate, the bonds of corporations have been as important a part of the gross estate as the total holdings of Federal bonds, including both the wholly and the partially exempt issues. For the estates under $1,000,000, the bonds of corporations have been relatively more important than all classes of public securities combined. If these figures accomplish no other purpose, they should demonstrate, first, that the very wealthy do not own all of the tax-exempt securities, State or Federal; and second, that the whole of every large estate has not been converted into tax-exempt securities to the neglect of all other forms of investment.

There is another side to this matter of investment in the debt obligations of governmental units. It will be recalled that during the war there was great pressure upon every one, regardless of his income, to subscribe to the war bonds. This became a measure of one's patriotism. It is often said that the ownership of tax-exempt securities by the wealthy constitutes a source of social unrest. But if the wealthy did not own any of these bonds, it would be very easy to turn this feeling into a wave of criticism against the wealthy "slackers" who refused to help the Government by buying its bonds.

(*f*) *An analysis of estate tax returns in Massachusetts.*—An analysis of 1,090 Massachusetts estates which passed through probate in the period December 1, 1931, to November 30, 1934, has recently been published. The author has the following to say about the distribution of all classes of tax-exempt security in these estates:[39]

"Now it has been alleged that the extreme increases in the rates applied in recent years under the Federal income tax must of necessity precipitate a flight on the part of the wealthy investor to the haven of refuge offered by the tax-exempt security. The present statistics indicate that the importance of Gov-

[39] Cf. Eugene E. Oakes, "The Liquidity of Large Estates in Massachusetts, 1932-1934," in bulletin of the National Tax Association, vol. XXIII, pp. 269-281 (June 1938).

ernment securities increases rapidly with the size of the estate. They also indicate, however, that the concurrent increase in the listed stock category has kept the Government bond in a subordinate position in most of the really large estates. The facts at hand do not seem to bear out the prediction of a flight to tax-exempts." [30]

(g) *Summary of the estimated ownership distribution of State and local bonds and of the interest thereon.*—The various figures given in preceding pages relative to the probable ownership distribution of State and local bonds, by categories of investors, are brought together in table VI.

TABLE VI.—*Assumed ownership distribution of State, local, and Territorial debt in 1937, and of interest thereon*

[Dollar amounts in millions]

Category of ownership	Estimated principal owned	Ratio to total debt	Estimated interest received on pro rata basis
Public trust and investment funds	$4,324	22.41	$180.0
Exempt institutions (mutual savings banks, fraternal benefit societies, foundations, universities)	1,458	7.55	60.6
Subtotal, held by nontaxable institutions	5,782	29.96	240.6
Taxable corporations (from appendix E)	5,043	26.14	200.0
Individuals with net income under $5,000	600	3.11	25.0
Individuals with net income of $5,000 and over (including partnership estates and trusts)	7,873	40.79	337.4
Subtotal, held by taxable corporations and individuals	13,516	70.04	562.4
Grand total	19,298	100.00	803.0

The procedure followed in allocating State and local bonds to personal ownership in the foregoing table is to assume that individuals own all of these bonds which cannot be assigned to any other category. It has been impossible to consult original sources in preparing this report and it has therefore been necessary to rely heavily upon such data as have been released by the Treasury Department. Since these data are most specific in the case of various types of corporate and institutional ownership, the writer was obliged to be most vague with respect to individual ownership. The figures given in table VI make no allowance for foreign holdings of State and local bonds. They are therefore an inflation of the amount actually owned by individuals with net incomes of $5,000 and over to this extent, and also to whatever degree that further, more intensive research into the question of ownership distribution may bring to light other blocks of these securities owned by some investor category not fully reported upon. A warning is therefore given here to the effect that the estimates of Federal tax yield given below, and based upon the ownership distribution assumed in table VI, will therefore be somewhat inflated by reason of the over imputation of State and local interest to the individuals with large incomes.

The amount assigned to the net income groups below $5,000, namely $600,000,000, is possibly too low. According to the Treasury Gray Book, the total holdings in these income groups as of December 31, 1934, was $507,000,000. This figure was obtained through a special sampling of income tax returns for 1934.[31] It is assumed that by 1937 this total would have risen to $600,000,000. Naturally it follows that all of the bonds which cannot be placed elsewhere are assumed to be owned in the net income groups above $5,000. Insofar as the amount thus allocated may be excessive, by reason of omissions in the reporting at other points, the estimate of tax yield given below will be distorted upward.

It should be noted, further, that the estimated interest which is allocated to corporations and to individuals with net incomes of $5,000 and over does not

[30] Loc. cit., p. p. 275.

[31] Treasury Gray Book, p. 101. In December 1938 the Treasury reported that total sales of savings bonds had passed the 2 billion mark. Such sales had been made chiefly to persons with small incomes, according to a sampling of the holders by means of a questionnaire. If the persons with small and moderate incomes bought about $1,250,000,000 of these bonds between March 1, 1935, and December 1937 it is not unreasonable to assume that the same persons may have increased their holdings of State and local debt obligations by some $93,000,000 in the same period.

correspond exactly with the relative amounts of principal assigned to those classes of owners. As explained in appendix E, a certain reconciliation and adjustment of State interest estimated to have been received by corporations in 1937 was necessary. The result of this adjustment was to impute a larger proportion of all taxable State interest to the net income groups of $5,000 and over than would be proper on a strictly pro rata basis. In consequence, there is some inflation of the estimate of Federal revenue yield from the taxes on these net income groups.

4. *Estimates of yield of Federal tax on State and local bond interest.*—It is next in order to proceed toward an estimate of the yield of Federal taxation of State and local bond interest. In doing this it is necessary to work from, and on the basis of, such data as are available relative to ownership distribution of these bonds. Since the yield of the tax will depend on the taxable status of those who receive the interest on these bonds, and since there are no complete records, by classes of owners, of the actual receipts of such interest, it has been necessary to approximate the distribution by ownership.

(*a*) *The tax yield from corporations.*—With respect to the $200,000,000 of State and local interest assumed to have been received by taxable corporations, allowance must be made for the amount received by corporations having no net income and hence having no income tax to pay. In appendix E are presented the details of a computation, based on the corporation tax returns for 1935 and earlier years, which leads to the conclusion that on the average only 60 percent of this State and local bond interest paid to corporations was received by corporations having net income. The computation is erroneous to the extent that the inclusion of this interest as taxable income would have changed some of the reporting corporations from a deficit to a net income status, but there is no known way of correcting the result for this error and it is not attempted. On the basis assumed, therefore, only 60 percent of the $200,000,000 of interest received by corporations would have been taxable, or $120,000,000. The tax on this amount is computed at 16½ percent, which is the ordinary rate of tax on corporate net income, under existing law, in case all earnings are currently distributed. The yield of the tax would therefore have been $19,800,000.

(*b*) *The tax on individual incomes below $5,000.*—The individuals with net incomes under $5,000 would not have been subject to surtax under the current schedule, except for the few cases in which the inclusion of State and local interest as taxable income would have shifted the recipients into a materially higher income bracket. In 1936 the highest effective rate of tax on all incomes under $5,000 was 0.84 percent.[32] On this basis the Federal taxation of the $25,000,000 of interest allocated to this group would have produced $210,000.

(*c*) *The tax on State and local interest in individual incomes of $5,000 and over.*—In table VI the total amount of interest from State and local bonds that was imputed, as of 1937, to the net incomes of $5,000 and over was $337,400,000. This is almost double the amount of such interest that was voluntarily reported by taxpayers in 1936.[33] It has been explained above that the amount actually reported is not necessarily correct, since no tax liability is involved, and it has also been explained that all interest on State and local bonds which could not satisfactorily be assigned to other categories of investors has been imputed to this particular class of taxpayer.

The amount of tax that would be paid depends, however, on the distribution of the bonds, and hence of the interest receipts, according to income brackets. If the entire amount of such interest were received in the very high income brackets, the tax would obviously be more than if it were all received in the brackets subject to low surtax rates.

It is clear that this matter of individual ownership distribution is the key to the problem of tax yield, for the bulk of such revenue as may be expected from the taxation of State and local bond interest must come from the individuals with net incomes of $5,000 and over. There is little room for doubt that the tax will cause some shift of ownership, but the direction and volume of this shift are quite unpredictable. There are, however, two rather frail indices which suggest what the ownership distribution of the taxable issues of State and local debt might be.

One of these indices is the ownership distribution pattern of the partially exempt Federal bonds interest on which is now subject to surtax, and exempt only from normal tax.[34] The other index is the existing ownership distribution pattern for corporate bonds, as revealed by the estate-tax returns. Neither of these indices can be relied upon as being anything more than a hint as to the kind of distribu-

[32] Cf. Statistics of Income, 1936, p. 39. "The effective rate" of income tax is obtained by dividing the entire taxable income into the total amount of tax collected thereon.

[33] The total reported for 1936 was $182,793,000. Cf. Statistics of Income, 1936, p. 30.

[34] The interest on a principal amount of $5,000 for each holder is wholly exempt.

tion to expect, but they are used here for lack of any other, more tangible clue as to where the taxable State and local bonds are likely to find lodgment in individual investment portfolios.

The detailed process of calculating the tax yield is shown in appendix F. Here the results only are important. The assumptions made in this calculation are also important, and they will be restated:

(1) Assuming that individuals with net incomes of $5,000 and over shall receive as much interest from state and local bonds as is imputed to them in table VI.

(2) Assuming that the ownership distribution pattern for State and local bonds will correspond with that of the partially exempt Federal bonds as revealed by the distribution of partially exempt Federal interest reported in 1936.

Then the tax to be collected on the $337,400,000 of State and local interest imputed to individuals with net income of $5,000 and over would be $77,055,000.

But if the ownership distribution pattern be assumed to correspond with that for corporate bonds, as revealed by the estate tax returns, then the tax yield would be $93,999,000.

The foregoing calculations of cost and revenue yield have been based on the conditions assumed to prevail when the volume of State debt subject to taxation becomes as large as the present immune debt. At that time the interest costs to State and local government should be about $113,000,000 annually above the figure reported as interest payment in 1937. Assuming a distribution of debt ownership similar to that of 1937, only about $79,100,000 of this additional interest would be paid to persons and corporations subject to Federal tax.

Using the methods employed here, the tax on this amount would be: On corporation incomes, $2,924,000; on individual incomes: (a) According to distribution of partially exempt Federal bonds, $11,259,000; (b) according to distribution of corporate bonds, $13,491,000.

The total Federal tax on State and local interest on individual incomes of $5,000 and over, under the new conditions, would therefore be (1) assuming a distribution corresponding with that of the partially exempt Federal bonds, $88,314,000; (2) assuming a distribution corresponding with that of corporate bonds, $107,490,000. An average of these results would be $97,902,000.

Summary of estimates of Federal tax yield from State and local bond interest.—The results of the estimates of Federal revenue from the taxation of all State and local bond interest are brought together in table VII.

TABLE VII.—*Estimated yield of Federal tax on State, local and territorial bond interest, including additional tax on assumed increase of interest cost caused by tax*

Class of taxpayer:	
Corporations (including tax on additional interest)	$22, 724, 000
Individuals with net incomes under $5,000	210, 000
Individuals with net incomes of $5,000 and over	97, 902, 000
Total	120, 836, 000

It will be recalled that cautions were given above relative to the possible inflation of the tax yield which would result from the imputation of more State and local bonds to the individual net incomes of $5,000 and over than are actually owned in these income groups.[35] The degree of inflation cannot be ascertained, but it is sufficient to prevent the acceptance of a figure of $120,800,000 with any assurance. If the holdings of foreigners should prove to be substantial, and this possibility is suggested by the steady influx of foreign liquid capital for a number of years, then the foregoing estimate is too high.

Further evidence that this figure may be too high is found in the following passage from an address given in 1937 by Dr. Roswell Magill, then Under Secretary of the Treasury: [36]

"Although exact data as to the distribution of State and local bonds by types of investors are not available, the best information which we have available leads us to estimate that if the Federal Government were authorized to collect Federal income taxes upon the interest of State and local bonds now outstanding, the additional revenue at existing levels of income and under the provisions of the present revenue law would be approximately $70,000,000 annually."

It is not easy to reconcile two estimates when one is some 71 percent greater than the other. Certainly the layman should not regard lightly an estimate

[35] Supra, pp. 119-120.
[36] National Tax Association, Proceedings of Thirtieth National Conference, 1937, p. 393.

offered by a responsible Treasury official as having been prepared on the basis of "the best information which we have available." Granting that Dr. Magill's work was carefully done, the only inference that remains is that the present writer's calculations have gone astray somewhere. An average of the two results would be an over-all Federal revenue of $95,000,000 from the taxation of the interest on State and local bonds as of the conditions prevailing in 1937.

Summary of Option I

The results of the option which assumes Federal taxation of State and local bond interest, with no waiver of Federal immunity from State taxation, are brought together as follows:

Loss to the States: Increased interest	$113,000,000
Gain to the Federal Government:	
Increased revenue	[1] 120,000,000
Do	[2] 70,000,000
Do	[3] 95,000,000

[1] Revenue gain, as estimated in the present report.
[2] Revenue gain, as estimated by former Under Secretary of the Treasury, Dr. Roswell Magill (supra, p. 121).
[3] Average of the two estimates.

From the discussion to this point it appears that the Federal revenue prospects from the taxation of State and local bond interest are somewhat variable, although all of the estimates are so low as to be disappointing to many, for there is a fairly general impression that the Government is experiencing a huge revenue loss through the tax immunity of State and local bonds. This loss would be substantial if the entire State and local debt were actually held by wealthy individuals and if they were to continue to hold all of it after the tax had been imposed.

On the assumption that the tax may be shifted to the debtor governments, there is some reason to accept Dr. Magill's estimate of the tax revenue as being more accurate than the one arrived at in the present report. In table VI it was shown that some $240,600,000 of the State and local interest paid in 1937 was received by agencies and institutions not subject to the Federal income tax. If this amount, on which no tax has been computed in any of the estimates, had in fact been taxed at the minimum rate applicable to corporations, i. e., 16½ percent, it would have produced approximately $40,000,000 in revenue. Adding this sum to Dr. Magill's estimate of $70,000,000, it produces a total Federal revenue, from the taxation of all State and local interest, of $110,000,000. This practically balances the estimated interest increase of $113,000,000.

In other words, if the total State and local interest paid had been taxable, and if the tax had been shifted in its entirety to the debtor governments, the revenue gain and the increased interest cost should about balance, and this balance is obtained if Dr. Magill's estimate of the revenue yield from the taxable interest be accepted.

On the other hand, if the revenue estimate arrived at in this report be accepted, the taxation of the total State and local interest would have produced a revenue in excess of the interest increase to the States. In view of the various assumptions which have been necessary in arriving at the estimate of revenue gain in this report, no opinion can be ventured regarding its superiority over that made by an official of the Treasury Department.

The next step of the inquiry is to bring into the account the effects of State taxation of Federal interest, in order to ascertain wherein this extension of State taxing jurisdiction may modify the outlook, on the fiscal side. This is done by an examination of the second option suggested above.[87]

Option II. Reciprocal Taxation of Bond Interest by the States and the Federal Government, with Continued Partial or Total Exemption of Federal Bond Interest from Federal Taxation

Under the second optional approach to the problem of tax exemption, certain facts in the situation would be much the same as in the first option, discussed above. That is, the Federal revenue gain, whatever it may turn out to be, would be the same as if the States had not been given power to tax the interest on Federal bonds. Likewise, the effect of the Federal tax on the cost of State and local borrowing would be the same.

[87] Supra, p. 106.

Two new factors are introduced, however, by the extension of the States' taxing power under this option. First, under certain conditions the States would realize some additional revenue and second, the interest cost of the Federal debt would be somewhat increased. The results of these changes, when added to those produced under option I, would lead to a revision of the summary statement given above.

1. *State revenue from taxation of Federal bond interest.*—The question of how much the States might expect to gain from the privilege of taxing the interest on Federal bonds is peculiarly complicated. Not all of the States now have income taxes, and it is evident, therefore, that not all of them could take immediate advantage of any waiver of Federal tax immunity. In a few cases it would require amendment of the State constitution before income tax legislation could be enacted, and in certain States very strong pressure would be required to persuade the people to accept a State income tax. In other places additional legislation would be required because some of the so-called State income taxes apply only to the income of business corporations. A considerable amount of recasting of State tax legislation would therefore be involved. In order to take advantage of the Federal waiver, every State would be obliged to enact a tax applicable both to personal and to business incomes, for the ownership of Federal securities will extend to business concerns as well as to individuals.

The problem of estimating possible State revenue gains from the taxation of the interest on Federal bonds is further complicated by the fact that no two of the State income-tax laws are alike. While all of the States have been obliged, by the growing weight of the Federal income tax, to keep their own rates of income taxation within moderate limits, some of them have applied progression and there is complete lack of uniformity in the rate brackets and in the steepness of the progression.

(a) *Federal interest subject to State taxation.*—The tax base which would become subject to State taxation is the total amount of interest paid on the obligations of the Federal Government and of its various agencies, less the interest receipts of (1) the several funds and agencies which hold certain amounts of these obligations, and (2) the interest receipts of exempt institutions. A computation of the apportionment of Federal interest paid in 1937, as between the public funds and exempt institutions on one hand, and private investors who would be subject to tax on the other, indicates that about $839,980,000 of this interest would be in the taxable category.

As shown below, some $565,000,000 of this amount was probably received by corporations in 1937, and the balance, or some $273,500,000, was received by individuals.[38] It is brought out in appendix E that year by year about 40 percent of the corporate receipts of Federal interest will be received by corporations having no net income. Hence the amount of taxable Federal interest received by corporations as of 1937 would have been some $339,000,000.

The typical maximum rate of State corporation income tax is about 4 percent and the typical maximum rate of individual income is about 5 percent. Therefore the maximum State income-tax revenue as of 1937 would have been:

Taxpayer	Taxable income	Rate	Tax
Corporations	$339,000,000	4	$13,560,000
Individuals	273,500,000	5	13,675,000
Total tax			27,235,000

But in 1937 there were 12 States which had no State income tax. In 1936 the individual taxpayers of these States paid 25.5 percent of the entire Federal tax on personal incomes.[39] If the above maximum State income tax be reduced in this ratio, it leaves $20,290,000 as the maximum State revenue from the taxation of Federal interest as of 1937. In view of the general graduation of rates below 5 percent, if the States had realized $17,000,000 from such a tax in 1937 it would have been a matter of congratulation to them.

[38] *Infra*, p. 137, and appendix E.
[39] Cf. Statistics of Income, 1936, p. 82.

(b) *The effect of the social security program on the future Federal interest taxable by the States.*[40]—The complete redemption of the Federal debt would, of course, reduce to zero the revenue prospects of the States from this source. While there is no immediate danger of a complete disappearance of the Federal debt, there is one possibility that much of it may disappear from the possession of those in whose hands the interest thereon would be subject to State taxation. This possibility is offered by certain aspects of the present plan for financing old-age benefits under the Social Security Act. According to that act, the excess of the appropriations to the old-age reserve account above current benefit payments is to be invested in debt obligations of the United States, or in those debt obligations of Federal agencies which are fully guaranteed as to principal and interest by the United States. Such investment must be on a 3 percent yield basis. If no eligible Federal securities can be bought on this basis in the open market, the Secretary of the Treasury is required to issue to the old-age reserve account special Treasury obligations bearing 3 percent interest.

To the present, the market yield basis of long-term Federal bonds has been below 3 percent and no open market purchases of Federal securities have been made for the account. If and when the Federal budget is again in balance, there will be no pressure to use the funds borrowed from the account through the issue of special obligations for current deficit financing and such funds will then be used, presumably, for debt reduction. This process means, in effect, a transfer of the Federal debt from the public to the old-age reserve account. But if, in future, the interest on Federal bonds should be made subject to State taxation, and if, also, the exemption from Federal taxation which is discussed under option III below, should be removed, then it is more than likely that the yield basis of Federal paper would rise to 3 percent or more. In such case, it would become profitable to use the old-age reserve account funds to purchase Federal debt obligations in the market.

As this process went on, resulting in a transfer of Federal debt from the public to the account, the tax base available to the States would be reduced and their revenue from Federal bond interest would also be reduced. In fact, if the goal set up by those who designed the social security program were to be achieved over the next 40 years, it is possible that a large part of the then existing Federal debt might be held by a Government agency. Should this happen, the Federal waiver of tax immunity would be an empty gesture. The Federal debt would be as great as ever, for the large reserve plan for old-age benefits contemplates a reserve of $47,000,000,000 by 1980; but being in the possession of a Federal agency the interest paid on it would still be immune from State taxation.

In weighing the fiscal aspects of such an apparently liberal and equitable proposal as reciprocal waiver of immunity, therefore, the States should consider most carefully the program that is likely to be developed in the field of social security financing.

(i) *Possible revocation of immunity waiver.*—The States should also consider with some care what their position is likely to be in any case, assuming that the waiver of Federal immunity is to be accomplished by statute only, rather than by constitutional amendment. It is a settled constitutional principle that no legislature can bind its successors. Without the protection of a constitutional guarantee, any future Congress could revoke such authorization as might have been extended by an earlier Congress to the States respecting the application of their income tax to Federal bond interest. Under these circumstances the waiver of immunity would also be an empty gesture.

2. *The effect of State taxation on Federal interest costs.*—According to table XV, the total interest cost of the debt issued by the Federal Government and its agencies was $1,148,000,000 in 1937. The computed rate of interest on the direct Federal obligations was 2.582 percent in this year, and on the obligations of Federal agencies the rate was 2.140 percent. The actual coupon rates on this debt varied from 4¼ percent on some of the earlier Treasury issues down to the inordinately low rates of discount at which the Treasury bills have been sold. The average investment yield basis of the longer maturity Treasury issues during 1938 has been about 2.40 percent. Assuming that under the average State income tax law the interest return from investment in Federal securities would be exposed to

[40] The advisory council on the social security program has just issued a report, December 1938, in which abandonment of the large reserve for old-age benefits is recommended. If this policy should be adopted, or to the extent to which it may be adopted, the situation discussed in this section would not arise. To whatever extent the Federal debt may be held by any of the security reserves in future, however, there would be a withdrawal from the effective tax jurisdiction of the States.

a maximum tax rate of 5 percent,[41] the yield adjustment required in order to offset the tax would be some 12 points in the rate. But a substantial part of the Federal debt is in short term low yield obligations, and the yield adjustment required to meet the State income tax would be much less than the 12 points which might emerge in the case of the long-term debt. Taking into account, therefore, the whole mass of long- and short-term Federal debt, and the proportions of the two forms, it is suggested that 7 points would be a reasonable average correction of yield basis. This average yield adjustment, applied to the total debt of the Federal Government and its agencies, as of 1937, would have produced an increase of interest cost amounting to $32,400,000. This figure will be rounded off to an estimate of $30,000,000 for the purposes of the present report.

Some question may arise as to whether the whole of this interest increase is to be expected in view of the fact that one-quarter of the States have no income tax. It is doubtful if this condition would affect the situation, for the following reasons:

(1) The procedure of marketing Federal securities could hardly be adjusted so as to sell part of a given issue in one State on one interest basis, and the remainder in other States on a different interest basis. The whole question of additional interest cost is settled, once for all, when the terms of issue are established. All that the Treasury could do would be to announce the terms, and in fixing them it would be necessary to consider the probable attitude of investors who would be subject to the State taxes.

(2) Even if investors in the non-income-tax States were willing to accept a different yield basis, they would thenceforth be obliged to carry the securities bought until they matured, or sell them within the State, or take a loss in selling them in an income-tax State. This fact would tend to temper their attitude toward a yield basis greatly different from that prevailing generally.

(3) The investors in the non-income-tax State would have no incentive to overbid those in the income-tax States, or at least there would be no necessity of overbidding to the full extent to the necessary yield differential. All they would need to pay would be one-eighth, one-sixteenth, or even one-thirty-second, more than anyone else to get what they wanted.

(4) Finally, all investors in the States which now have no income tax would need to be on guard against the possible enactment of such a tax at some future time.

Consequently, it appears more logical that Federal bond prices and bond yields in the non-income-tax States would follow closely the price and yield structure established in the States which taxed Federal interest, rather than the other way round. If this position be correct, then the fact that some of the States do not now tax incomes would make little, if any difference, in the effect of State income taxation upon the interest cost of the Federal debt.

Summary of Results Under Option II

States:		Federal Government:	
Gain	$17,000,000	Loss	$30,000,000

Restatement of combined results under options I and II

[Millions]

States:			
Loss, from option I			$113
Gain, from option II			17
Net loss			96
Federal Government:	(a)	(b)	(c)
Gain, from option I	$120	$70	$95
Loss, from option II	30	30	30
Net gain	90	40	65

(a) Revenue gain as estimated in this report.
(b) Revenue gain as estimated by Dr. Magill (supra, p. 121).
(c) Average of estimates (a) and (b).

It appears from this restatement of the results which may be expected under a general waiver of tax immunity as between the Federal Government and the States, that under the most favorable assumptions, the net loss to the States

[41] In 23 States, the maximum rate of personal income tax was 5 percent or more as of 1937. In 7 States it was 4 percent to 4.5 percent, and in only 3 States was it below 4 percent. Maximum rates of corporation income tax were in general somewhat lower, but in 13 States this maximum was 5 percent or above in 1937. *Cf.* Commerce Clearing House, Tax Systems of the World, Seventh Edition (1938), passim.

would exceed the net Federal gain by the small margin of some $6,000,000 annually. Under less favorable conditions, which are established by the estimate of Federal revenue gain published a year ago by a high Treasury official, the Federal net gain would be less than half of the probable net loss to the States. If the Federal net gain be taken as an average of Dr. Magill's figure and that arrived at in the present report, the result would still be less than the cost of the tax changes to the States.

Incidence of the gains and losses.—A balancing of the gains and losses such as is given here might be said to support either side of the argument. That is, if reciprocal immunity be waived, the losses may be offset, in substantial part, by the gains. Or if the present status be maintained, the revenue loss would be counterbalanced by an advantage in the form of lower interest costs.

It is significant, however, that these gains and losses, respectively, would fall upon different groups of citizens. The additional revenue gain would be obtained from the relatively small number of persons whose incomes are such as to subject them to the higher rates of income tax. The additional interest costs, especially in the case of the States and cities, would be paid by the millions of persons with small incomes, small properties, and small businesses, who now pay the bulk of all the taxes for the support of State and local government.

Reduced to its fundamentals, therefore, the fiscal side of the tax-revision issue which is presented under options I and II is a question of increasing the taxes paid by all of the citizens who now support State and local government, in order to increase the taxes of those few other citizens who are not now paying quite as much as they otherwise would pay to the Federal Government because of the loans which they have made to the States and cities. More will be said on this subject in part II below.[42]

3. *Further consideration of the effects upon the States and cities.*—It is obvious that an extension of Federal taxing jurisdiction to include State and local bond interest will result in an increased burden for interest costs that will materially exceed any revenue which the States can hope to obtain by taxing Federal interest. It is impossible, and likewise unnecessary, to attempt a detailed apportionment of the relative gains and losses to each State. In general, the following factors should be considered:

(1) The non-income-tax States will have no gain in revenues from the waiver of Federal immunity, but the extension of Federal taxation to the interest on their bonds will increase proportionately the cost of their State and local debt. A suggestion may emerge in the course of the discussion of this subject, to the effect that the States and cities should be reimbursed from the Federal Treasury for the increased debt cost caused by the tax. Only a most incredibly naive person would assume that an equitable apportionment of this grant could be made, in view of the great number and variety of local units to be dealt with in the distribution. Since there could not be even a beginning of an equitable reimbursement, the outcome of a Federal subsidy of this sort, granting that the state of the Federal finances warranted its appropriation, would be a distribution on such basis as the Federal Government might determine, or as the local units might obtain through the political influences at their command.

There has been too much of the Federal subsidy, as such, for the maintenance of the healthy morale of the States and cities. The privilege of borrowing without the restrictive interference of Federal taxation is likely to appeal to these units as a better way of serving the local advantage than a Federal grant to meet a burden caused by a Federal tax.

(2) The majority of the income-tax States may expect very little advantage from the Federal waiver, because there is no material concentration of Federal bonds in the estates of their citizens. The State income taxes are of minor importance today, as a source of revenue, in all but a few of the States in which this tax is found. It is extremely unlikely that the relative fiscal significance of this tax would be greatly altered for these States simply by permitting them to include Federal bond interest in the taxable incomes of their people. But the interest costs of all of the minor income-tax States would also be proportionately affected by the inclusion of State interest in the taxable incomes of Federal taxpayers.

In fact, it is quite possible that some of these States and their subdivisions would suffer an increase of interest costs materially above that which has been assumed here as an average, Nation-wide rise. It is a well-known fact that the credit rating of both the States and the cities varies considerably. The comparison from which was deduced an average increase of 60 points in State interest cost, under the impact of Federal taxation, was based on the highest grade

[42] Infra, pp. 147, 148.

municipal securities. As the credit rating declines, the relative cost of borrowing goes up, and it may rise more than proportionately. Here, at any rate, is something for a considerable proportion of the States to consider rather carefully in weighing the fiscal pros and cons.

(3) A few States would reap the great bulk of any revenue advantage that might flow from State taxation of Federal bond interest. Such is the case today, with respect to State income taxes, for it is only in these few States that the income tax supplies a proportion of State and local revenue of any consequence. In some cases, it is possible that the revenue gain to a State might equal or exceed the additional cost of carrying the State and local debt. Should this occur in any instance, it would be the result of a fortunate combination of very large holdings of Federal bonds, together with relatively low debt costs. The gain of such a State could only be at the expense of many other States in which the rise of debt cost exceeded the revenue gain from taxing Federal interest.

In connection with this point, a summary statement of total State and local debt as of some date in 1937, together with the income tax collections and total State and local tax collections as of 1936, is presented in table VIII.[43]

TABLE VIII.—*State and local gross debt, income tax collections, and total State and local tax collections*

[Thousands of dollars]

State	State and local gross debt, 1937	1936 tax collection		Total income tax collected	Total State and local tax collected	Percentage income tax to total taxes collected
		Corporation income	Personal income			
Alabama	205,170	467	389	856	54,892	1.56
Arizona	60,369	406	407	813	27,065	3.00
Arkansas	263,119	191	189	370	33,917	1.09
California	1,516,030	14,989	6,526	21,515	326,509	6.59
Colorado [1]	150,209				58,271	
Connecticut	181,693	3,549		3,549	101,397	3.50
Delaware	24,846		910	910	14,229	6.40
Florida	462,845				97,539	
Georgia	89,406	1,388	706	2,094	74,561	2.81
Idaho	73,508	569	380	949	33,350	2.85
Illinois	1,179,427				434,267	
Indiana	156,708				155,136	
Iowa	209,547	486	3,260	3,746	140,769	2.66
Kansas	130,960	534	1,049	1,583	79,728	1.98
Kentucky [1]	132,185				74,225	
Louisiana	347,464	1,274	925	2,199	70,931	3.24
Maine	68,767				41,223	
Maryland [1]	306,073				85,104	
Massachusetts	672,278	2,258	16,570	18,828	307,324	6.13
Michigan	744,681				343,150	
Minnesota	353,203	2,398	1,199	3,597	148,627	2.42
Mississippi	172,377	384	489	873	50,620	1.72
Missouri	383,605	2,211	3,317	5,528	149,898	3.69
Montana	72,992	350	380	730	32,157	2.27
Nebraska	104,064				55,036	
Nevada	12,199				7,925	
New Hampshire	39,789		405	405	27,430	1.47
New Jersey	1,328,367				298,520	
New Mexico	52,010	108	72	180	18,035	1.00
New York	4,534,264	44,168	85,901	130,069	1,200,770	10.83
North Carolina	520,304	5,836	1,729	7,565	82,591	8.61
North Dakota	57,582	91	222	313	27,213	1.15
Ohio	811,717		5,681	5,681	333,970	1.70
Oklahoma	188,599	3,059	1,668	4,727	87,965	5.37
Oregon	205,275	855	1,679	2,534	57,373	4.42
Pennsylvania	1,466,544	12,963		12,963	537,832	2.41
Rhode Island	149,577				38,208	
South Carolina	136,602	1,293	899	2,192	49,951	4.39
South Dakota	84,738	49	50	99	32,895	.30
Tennessee	344,716	373	824	957	69,058	1.38
Texas	735,741				290,882	

[1] These States enacted income tax laws in 1937.

[43] The State and local debt figures are from the Treasury Gray Book. State income tax collections, and total State and local taxes, are from Tax Systems of the World, 7th ed., p. 391, except that in the cases in which a higher figure for the income tax yield was given in the Twentieth Century Fund publication Facing the Tax Problem, the higher figure was used, in order to make the best possible showing for the present State income taxes.

TABLE VIII.—*State and local gross debt, income tax collections, and total State and local tax collections*—Continued

[Thousands of dollars]

State	State and local gross debt, 1937	1936 tax collection		Total income tax collected	Total State and local tax collected	Percentage income tax to total taxes collected
		Corporation income	Personal income			
Utah	47,123	508	499	1,007	26,538	3.79
Vermont	25,995	97	399	496	17,687	2.76
Virginia	203,074	1,800	1,022	2,822	67,454	4.18
Washington	240,578	.....	.....	.....	91,114	.....
West Virginia	134,034	.....	1,150	1,150	81,149	1.42
Wisconsin	171,593	6,598	5,987	12,585	162,391	7.69
Wyoming	39,951	.....	.....	.....	11,723	.....
Total	19,691,388	109,242	144,643	253,885	6,611,758	3.84

(a) *Minor fiscal importance of State income taxes.*—This table confirms what has been said regarding the minor fiscal importance of the State income taxes. In only one State was the proportion of income tax to all State and local tax revenues above 10 percent in 1936, and in only 6 States was the proportion above 6 percent. It is evident that the fiscal situation of the great majority of the income tax States would not be materially altered by extending to them the privilege of taxing the interest on Federal securities. Furthermore, 15 States had no income tax at all in 1936, and in 2 States, Connecticut and Pennsylvania, the tax applied to corporation incomes only. At present, there are 12 States with no income tax.

The gross State and local debt situation is in interesting contrast with the State income tax possibilities. In Alabama, Arkansas, Ohio, and Tennessee, for instance, the debt total is relatively large while income tax receipts are but a small proportion of total tax receipts. North Carolina's income tax is a somewhat better revenue producer, in relation to total State and local tax collections, but the gross debt of the State and its subdivisions is also substantial.

The prospects that the leading income tax States might be able to collect enough tax on Federal interest to offset their respective interest costs may be considered by comparing the probable increase of their interest costs assuming an average increase of 60 points in yield basis, with the amount which they are now collecting in income tax. This is done in table IX.

TABLE IX.—*Comparisons of gross State and local debt, assumed increase of interest cost, and current income tax collection, in certain States*

State	Gross debt	Assumed increase of interest cost on average rise of 60 points	Income tax collections in 1936	Ratio of interest increase to total 1936 income tax collection
California	$1,516,030,000	$9,096,000	$21,515,000	42.2
Delaware	24,846,000	149,000	910,000	16.3
Massachusetts	672,278,000	4,034,000	18,828,000	21.4
New York	4,534,264,000	27,206,000	130,069,000	20.8
North Carolina	520,304,000	3,122,000	7,565,000	41.2
Wisconsin	171,593,000	1,030,000	12,585,000	8.2

The States in this table are those in which the total income tax collections amount to more than 6 percent of all reported State and local tax collections. From the standpoint of their relative income-tax collections, they may be called the leading income-tax States, although this merely emphasizes the comparative unimportance of the State income tax as a revenue resource, for New York is the only State in the list which collects income taxes to an amount exceeding 10 percent of total taxes. Delaware and North Carolina may be ranked among the leading income-tax States because of the relatively low total tax collections rather than because of large income-tax receipts. The other four States stand out, despite

large total taxes, on account of the comparatively large number of large incomes received by their respective residents.

In table IX the increased interest cost, based on an average of 60 points in the yield rate of all State and local debt, reveals how much more each of the above States would be obliged to obtain from its income tax than was collected in 1936, in order to break even if Federal bond interest were made taxable. The four States in the above table which have the best prospect of breaking even, through collecting enough more in income tax to offset the estimated increase of interest are Delaware, Massachusetts, New York, and Wisconsin. But if New York were to succeed in collecting enough from a tax on Federal interest received by her residents and by the corporations doing business in the State, to offset her increased interest cost, it would be necessary to equal the total revenue estimated to be collected by all of the States on the entire amount of Federal interest.

(*b*) *Position of the non-income-tax States.*—The States which have no income tax must either forego all chance at revenue from the taxation of Federal interest, or take such steps as may be required to compel local acceptance of this form of taxation. The debt position of these States, and the probable effect of a Federal tax on their interest costs, are shown in table X.

It appears that almost 30 percent of the gross State and local debt is carried by the States which now have no income tax, and that the increased interest cost of carrying this volume of debt, on the basis of an average increase of 60 points, would be $31,453,000 annually. This increase is, in itself, considerably more than all of the States could reasonably expect to obtain from the taxation of Federal interest under existing conditions.

TABLE X.—*Gross State and local debts, and probable increase of interest costs, in the non-income States, as of 1937*

State	Gross debt	Increased interest cost of basis of 60-point spread
Florida	$462,345,000	$2,774,000
Illinois	1,179,427,000	7,077,000
Indiana	156,708,000	940,000
Maine	68,767,000	413,000
Michigan	744,681,000	4,468,000
Nebraska	104,004,000	624,000
Nevada	12,199,000	73,000
New Jersey	1,328,367,000	7,970,000
Rhode Island	149,577,000	897,000
Texas	755,741,000	4,534,000
Washington	240,578,000	1,443,000
Wyoming	39,951,000	240,000
Total	5,242,345,000	31,453,000

In the light of the evidence supplied in table X, and on the basis of the probable total revenue which the States might expect, it would be futile for many of the States which now have no income tax to introduce one simply for the purpose of equalizing, or attempting to equalize their revenue gain with their increased interest cost. In a few of the non-income-tax States the gain from such a tax might be sufficient to diminish materially the extra burden caused by the Federal tax on their own interest costs. In other States it is quite out of the question to expect any such equalization.

It is, however, a rather cold-blooded position to take, if it be insisted that every State should have an income-tax law, or that each of the 48 States should have exactly the same kind of revenue system in all other details. To be valid, such a position must rest on the assumption that the economic and business conditions in the several States are sufficiently similar to warrant complete uniformity of taxation methods. For various reasons some of the States have preferred to deal with the same problem in different ways. For example, some States have undertaken to tax intangible property of every sort through an income tax, while other States have preferred to use a system of classified property taxes. One method is as good as the other for the purpose. Some of the income-tax States are using both an income tax and ad valorem taxes on intangible property. It is extremely doubtful if any State would be permitted to tax Federal bonds under a property tax. If Federal immunity is waived, they must use an income tax or nothing. Insistence upon uniform application of the income-tax method is

a kind of compulsion exerted against all of the States to adopt one, and only one, method of dealing with the problem of taxing intangible property including public securities, regardless of the wishes, preferences, constitutional provisions, or other local conditions which have caused, historically, the emergence of variations in the taxation methods of the several States.

The tax-exemption amendment that was discussed in 1922 limited the reciprocal waiver of immunity to the income tax. The writer of this report criticized the form of that proposal as follows: [44]

"This amendment was defective in that it restricted the States to income taxation. It should have permitted the States to tax either the income from Federal securities, or to tax such securities as property under a classified property tax at the same flat rates as might be imposed on other classes of securities in that State."

In connection with the discriminatory treatment of the States which any single form of Federal waiver may take, the following extracts from the hearings on the amendment of 1922 are apropos: [45]

"Mr. GARNER. Now, Mr. Mills, is it not fair to refer to the phase of this proposed amendment which permits States and counties to tax Federal bonds? I have never heard you express yourself on that phase of it.

"Mr. MILLS. Well, I take it that we have got to consider this proposition as representatives of the National Government. What the States will do with it afterwards is a very different question, and I think my vote in the State legislature might possibly be different from my vote in the National Legislature, although I do not want to commit myself on that point. We have got to look at this from the national standpoint. We are giving to the States the privilege to be sure, of taxing national securities, but in return, we are getting a greater mass of securities that on the whole are going to constitute a much larger tax basis than the Federal securities are. And what is more, we are asking for the benefit—and we are getting the benefit—of taxing them at a much higher rate than the States are likely to do. You are only giving to the States the privilege of taxing income from these bonds.

"Mr. GARNER. That is what I was going to call to your attention.

"Mr. MILLS. And there are only four States in the Union today that have income taxes. All of the other States, or the majority of the States, tax securities as property, which they generally classify as the property tax.

"Mr. GARNER. We are asking the States in this amendment to surrender their right to issue tax-free securities.

"Mr. MILLS. Yes, sir.

"Mr. GARNER. And to invest unlimited power in the Federal Government for tax purposes?

"Mr. MILLS. Yes, sir.

"Mr. GARNER. But we are not giving to the States the same right that they are extending to the Federal securities. We are limiting it to an income tax.

"Mr. MILLS. You can tax them under an income-tax provision.

"Mr. GARNER. And the States and counties, of course, levy direct taxes on property. That is the only method they have for collecting taxes. I do not know whether that is the system in your State, but that is the only method we have in Texas.

"Mr. MILLS. No; we have an income tax.

"Mr. GARNER. We have direct taxes. That is the only way they have of collecting taxes. For instance, if I give you a note you will have to pay taxes on that note as such.

"Mr. MILLS. You tax it on the same basis as real property.

"Mr. GARNER. If we are going to give the States that power, why limit the States in their privilege of taxing Federal securities? Why not give them the entire right to tax them.

"Mr. MILLS. Now, Mr. Garner, I think you are arguing from the standpoint of the State, and I think when it comes to ratification that the States will be very able to take care of themselves. What we are going to do is to consider it from a national standpoint and from that standpoint which will produce the most revenue and is most economically correct. There is not the slightest question that this great tax exemption evil should be done away with. And the only way that the State can remedy that is to pass an income tax law.

[44] H. L. Lutz, *Public Finance*, 2d Ed. (1929), p. 584.

[45] Hearings before the Committee on Ways and Means on Tax-Exempt Securities, 67th Cong., 2d sess., 1922, p. 71.

"Of course, that brings pressure to bear on them to tax incomes under this plan. We have an income-tax law. Massachusetts followed and also Missouri, but they are only four States that tax incomes.

"Mr. OLDFIELD. What States are they?

"Mr. MILLS. Missouri, Massachusetts, New York, and Wisconsin.

"Mr. COLLIER. Mississippi has an income tax.

"Mr. OLDFIELD. And I believe Oklahoma has an income tax.

"Mr. MILLS. But they have not substituted the income tax for the other taxes?

"Mr. COLLIER. No; they have not done that.

Mr. Mills' position in the above colloquy was engagingly frank, but obviously disingenuous. He virtually admitted that as a national legislator he was urging something of which he would disapprove as a State legislator. Moreover, had the amendment which he was supporting been submitted to the States, their only method of "taking care of themselves" would have been to reject it. Certainly it would have been too late then to open the way for the procedure which Mr. Garner was proposing.

The conclusion arrived at by Mr. Mills, that the only way of ending the "tax-exemption evil" is for the States to pass an income-tax law, is a complete non sequitur. These alleged evils can be quite as effectively removed, so far as concerns the States, by authorizing them to tax Federal bonds, without discrimination, as other intangible property is taxed, as by authorizing them to tax the interest on these bonds under an income tax.

(c) *Position of the cities.*—The fiscal effects of the proposed tax changes upon the local governmental units, particularly the cities, should be especially considered in any balancing of the gains and losses. The situation involves, among others, the following elements:

(i) Local debts are far more, in the aggregate, than the State debts and the cities are the largest single debtor class in the local group. According to table II, the debt of all local units in 1937 was $15,911.3 millions, or 83 percent of the total. It follows, therefore, that 83 percent of any increase in interest costs, following the imposition of a Federal tax, will be borne by the various classes of local debtor units, and that more than half of the total increase will fall upon the budgets of the cities;

(ii) Local governmental subdivisions in the United States are limited, in their exercise of the taxing power, very largely to the property tax. A perpetual struggle goes on, between the cities and their taxpayers on one hand, and between the cities and their respective States, on the other. The taxpayers resist increase of the property tax, and the cities are pressing for larger participation in the State-collected taxes. Various schemes are in operation for grants to local units, and for sharing the State-administered taxes, but nowhere can there be found a completely satisfactory solution for the combination of difficulties which beset the cities;

(iii) Many local units would be obliged to pay more than the average increase of 60 points in order to market bonds subject to Federal taxation. It is possible that some of them would encounter serious difficulty in finding buyers at all under existing legislative restrictions as to interest rate and terms of sale.[46] For all such communities the increase of interest cost would be far greater, proportionately, than that which has been assumed in this report to be a national average;

(iv) The extent to which the cities might share in any income-tax receipts is problematical. In a few States the yield of the income tax is shared, in others it is a State revenue. In all of the latter States, such gains as were realized from the State tax on Federal interest would go into the State treasury, while the onerous task of meeting the higher costs caused by the Federal tax on local bond interest would fall on the local governing bodies.

(d) *Effect of Federal taxation of State and local interest upon the tax rates of certain cities.*—The best method of visualizing the effect of Federal taxation of State and local interest is to consider some specific cases. The matter comes closest home in the case of the cities. The table which follows gives certain

[46] An interesting case of juggling to circumvent statutory restrictions is reported by the New York Special Joint Commission. An amendment to the New York tax law of 1926 provided that the insurance companies, banks, and other financial corporations owning New York State securities on which the interest did not exceed 3 percent, should have a credit of 1 percent of the par value to be applied against franchise taxes payable by such corporations. The explanation was that certain 3-percent bonds were not marketable at that rate, hence an indirect subsidy was provided, making the actual interest rate equivalent to 4 percent. *Cf.* Special Joint Committee on Taxation and Retrenchment, Tax Exemption in State of New York (1927), pp. 83, 89.

pertinent data for all of the cities having a population of 500,000 and over in 1936.[47]

TABLE XI.—*Gross debt, interest paid in 1936, increased interest cost that would be caused by Federal taxation of municipal interest, tax levy per $1,000 in 1936, and effect of the Federal tax on the local tax levy*

City and State	Gross debt (000)	Interest paid 1936 (000)	Increased interest cost, assuming 60 and 20 points change of yield basis for long- and short-term debt respectively (000)	Tax levy per $1,000, 1936	Tax levy adjusted to include increased interest
New York, N. Y.	$2,524,017	$99,212	$14,293	$27.14	$28.01
Chicago, Ill.	701,898	21,166	3,394	95.20	96.93
Philadelphia, Pa.	636,329	26,319	3,727	20.24	21.27
Detroit, Mich.	443,107	29,879	2,645	27.90	30.00
Los Angeles, Calif.	291,825	12,442	1,729	32.06	33.01
Cleveland, Ohio	159,102	7,691	930	28.61	29.39
St. Louis, Mo.	89,583	3,500	537	26.89	27.35
Baltimore, Md.	188,789	7,700	1,133	21.69	22.19
Boston, Mass.	188,963	8,288	1,060	37.74	38.39
Pittsburgh, Pa.	155,535	6,446	931	37.14	37.99
San Francisco, Calif.	173,892	7,769	1,029	26.76	27.68
Milwaukee, Wis.	70,293	3,057	396	32.27	32.69
Buffalo, N. Y.	150,198	5,746	870	33.96	34.87

The last two columns of the above table tell the story of the effect of a Federal tax on the interest paid on municipal obligations, on the assumption of a 60-point increase of the interest rate, and of 20 points increase on the short-term debt. The amount by which the property-tax levy would have been increased, under the conditions prevailing in 1936, would have ranged from 42 cents per $1,000 in Milwaukee to $2.10 per $1,000 in Detroit. It should be noted, furthermore, that Detroit would have no opportunity of recovering any part of this increase through the taxation of Federal interest, since Michigan has no State income tax.

The especially unfortunate position of the non-income-tax States has been referred to above. It is desirable to observe the effects of the Federal tax upon the local tax rate in some of these States. The effect upon Chicago, Detroit, and Baltimore is shown in the above table. The situation in all of the remaining cities with a population of 100,000 and over which are located in States having no income tax, is given in table XII.

[47] Data for the next two tables in the text are from Financial Statistics of Cities, 1936, issued by the Bureau of the Census.

In the case of the three cities—Los Angeles, Philadelphia, and Pittsburgh—the amount given above as the tax-rate levy for 1936 was computed by dividing the total assessment of real and personal property into the total amount of taxes raised. As reported by the Census Bureau, certain portions of the tax were not extended against the entire mass of the property assessment.

TABLE XII. *Effect of the Federal tax on the interest cost and local tax rates in certain cities located in States having no income tax*

City and State	Gross debt (000)	Interest paid 1936 (000)	Increased interest cost, assuming 60 and 20 points change of yield basis for long- and short-term debt, respectively (000)	Tax levy per $1,000 of assessed value, 1936	Tax levy adjusted to include increased interest
Jacksonville, Fla	$14,733	$746	$88	$42.43	$43.65
Miami, Fla	39,121	1,915	231	43.56	45.69
Tampa, Fla	18,043	885	104	53.15	54.46
Peoria, Ill	5,837	182	33	45.80	46.22
Indianapolis, Ind	41,030	1,824	243	29.70	30.18
Fort Wayne, Ind	5,202	238	31	23.76	23.97
South Bend, Ind	5,670	269	34	24.59	24.85
Gary, Ind	5,698	265	34	33.20	33.47
Evansville, Ind	5,630	198	33	30.34	30.62
Grand Rapids, Mich	16,459	781	97	22.51	23.04
Flint, Mich	19,423	961	114	29.22	29.89
Omaha, Nebr	30,626	1,447	181	30.73	31.40
Newark, N. J	148,748	6,639	885	38.18	39.15
Jersey City, N. J	93,318	4,204	553	45.81	46.71
Paterson, N. J	32,812	1,541	197	43.92	45.03
Trenton, N. J	22,453	920	126	36.87	37.61
Camden, N. J	28,606	1,316	168	43.15	44.38
Elizabeth, N. J	17,534	646	105	38.56	39.29
Providence, R. I	67,583	2,409	378	19.79	20.38
Houston, Tex	60,229	2,817	359	44.62	45.88
Dallas, Tex	39,234	1,738	233	34.55	35.38
San Antonio, Tex	30,417	1,497	179	33.89	34.75
Fort Worth, Tex	28,004	1,205	166	41.38	42.40
El Paso, Tex	8,598	452	51	34.98	35.60
Seattle, Wash	103,288	4,435	573	52.54	54.82
Spokane, Wash	4,593	183	26	45.47	45.83
Tacoma, Wash	15,850	722	90	57.82	59.64

The last two columns of this table tell the story of the effect that will be produced in the larger cities by the Federal taxation of the interest on their bonds. The property tax rates would probably be increased in some of these cities by more than the amounts shown in the above table, for the estimated increase of interest cost was computed in every case on the basis of a 60-point advance in the yield rate. Some of the cities in the above list are not in the top grade, from a bond investment standpoint, and they would in all probability pay more than 60 points in excess of the present yield basis of their loans after the interest thereon became taxable.

In contrast with the situation in the States having no income tax, it will be worth while to consider how some of the cities in New York State would be affected. The following table contains some relevant data:[48]

TABLE XIII.—*Estimated increase of interest, effect on tax rates, and amount received under existing State income tax, in the cities of New York State with a population of 100,000 and over*

City	Estimated interest increase	Tax rate, 1936, per $1,000 of assessed value	Tax rate adjusted to include interest increase	Amount received in 1937 as a distribution of—	
				Personal income tax	Business corporation tax
New York City	$14,293,000	$27.14	$28.01	$10,697,000	$5,675,000
Buffalo	870,000	33.96	34.87	620,400	528,700
Rochester	463,700	36.93	37.66	401,400	365,300
Syracuse	243,200	30.25	30.89	238,500	143,500
Yonkers	215,400	33.57	34.24	203,300	35,400
Albany	234,100	32.88	33.88	149,900	87,300
Utica	252,700	41.01	42.94	84,100	34,500

[48] Data used in the first three columns from the Census Bureau's publication, Financial Statistics of Cities, 1936. Data for the last two columns, from the Report of the New York Tax Commission, 1937, table 33.

The effect on the tax rates of New York cities, when adjustment is made to provide for an increase of tax levy sufficient to cover the higher interest cost, is found to be about the same as it would be in other States. In the last two columns of the table are given the amounts which these cities actually received, in 1937, as their respective shares of the State taxes on all personal and business net incomes. It is significant that the estimated additional interest cost is greater than the amount now being received as the local share of the entire State tax on personal incomes, notwithstanding that this tax was collected in 1937, at the specially increased rates which have been imposed as a temporary measure. Assuming that New York would continue the present policy of sharing income-tax receipts with the local units, in the event that Federal immunity were waived, it is clear that none of these large cities could expect to receive more than a small fraction of the amount by which their interest costs would be increased. It will be noted that in the case of Utica, the increase of interest cost exceeded the city's share from both of the State taxes levied on net incomes in 1937. Albany's share of both taxes was barely more than the interest increase, and even in the case of New York City, the excess of total income-tax apportionments over the estimated additional interest was only a little more than $2,000,000.

The effect of the Federal tax and debt costs and local tax rates in the leading cities of New York and New Jersey is shown in tables XII and XIII. It will be interesting to consider the over-all effects of the tax on State and local interest costs in these States, in the light of the developments in State and local borrowing from 1932 to 1937. The significant figures are given in table XIV.[49]

TABLE XIV.—*Interest paid in New York and New Jersey in 1932 and 1937, by classes of governmental subdivisions, and increased interest costs of the 1937 debt on the basis of a 60 point rise in interest rates*

NEW YORK

	Actual interest paid 1932	Actual interest paid 1937	Actual increase, 1937 over 1932	Additional cost produced by 60 point interest rise on 1937 debt total
State debt	$17,752,000	$20,145,000	$2,393,000	$4,412,000
Municipal debt	110,350,000	122,767,000	12,417,000	18,967,000
Other local debt	17,641,000	26,154,000	8,513,000	3,866,000
Total	145,743,000	169,066,000	23,323,000	27,245,000

NEW JERSEY

State debt	$3,863,000	$7,386,000	$3,523,000	$1,037,000
Municipal debt	34,963,000	34,758,000	[1] 205,000	5,051,000
Other local debt	16,044,000	11,625,000	[1] 4,419,000	1,882,000
Total	54,870,000	53,769,000	[1] 1,101,000	7,970,000

[1] Decrease.

The Federal tax would cause an increase of debt cost, for New York, greater than the actual increase from additional borrowing during the 5 years. The total interest payments in New Jersey actually declined by more than $1,000,000 from 1932 to 1937, but the Federal tax would increase the cost over the 1937 total by almost $8,000,000. The additional burden on the taxpayers of New York State alone would equal all that all of the States could reasonably expect from the taxation of Federal interest, assuming universal use of State income taxes. The increased burden on New Jersey taxpayers would be almost one-half of the amount which all of the States that now have income taxes could expect to receive from the taxation of Federal interest.

It is clear, also, that in these States as in others, the bulk of the increased burden would fall on the municipal and other local budgets.

(e) *The local consequences of increased local tax rates.*—The effects of local tax rate increases should be considered in connection with the efforts that are being made in various places to put local financial management on a better basis. In

[49] Data from the Treasury Gray Book, p. 68.

New Jersey, for instance, laws were enacted a few years ago which looked toward a cash basis for current county and municipal operations. In substance, the local budgets were required, by this legislation, to carry two new items; (a) an appropriation item entitled "reserve for uncollected taxes;" and (b) a receipts item entitled "anticipated delinquent tax collections." If the two items should balance, no effect on the tax rate would ensue, but if the collection of delinquent taxes should fall below anticipation, the tax rate would go up in the next year to cover the excess of appropriated reserve over actual receipts.

Property-tax delinquency, in New Jersey and elsewhere, tends to vary with the tax rate.[40] The effect of the Federal tax would be to increase the local tax rates, as the volume of debt subject to the tax rose, and this upward movement of the tax rates would produce relatively greater tax delinquency. The cities would be obliged to increase their appropriated reserves for delinquent tax collection, since the collection would be slower and more uncertain. The difference between appropriated reserve and actual delinquent collections would compel the budgeting of a tax overlay in subsequent years, and this would in turn cause a further rise of the tax rate that would intensify the difficulty. With the "snowballing" effect thus produced, it might be impossible for many communities to maintain a cash basis budgetary position.

Were an effort made to counteract the rising tax rates and increasing tax delinquency through more rigorous enforcement of collection procedure, the result would be a larger number of tax sales and a relatively larger loss of equities in homes and other small properties through final foreclosure of the tax title liens.

(f) *Tax exemption and municipal ownership.*—When the tax-exemption amendment was under discussion, in 1922, it was opposed by those who favored the municipal ownership of various utilities, such as water and electric power.[41] It was reported at the time that the private utilities favored the amendment in order to end the advantage which the cities enjoyed, through tax immunity, in their loans to introduce municipal ownership.

This subject is again to the fore, for the Federal Government has been actively engaged in furthering municipal ownership, in the area served by the Tennessee Valley Authority and elsewhere. The present report takes no position on the municipal ownership issue, but it should be pointed out that the Federal taxation of State and local bond interest would accomplish much of what it was said that the opponents of municipal ownership hoped for from the earlier amendment.

(g) *State and local agencies without the taxing power.*—In various States there are public agencies which are authorized to issue bonds, and which are required to use this method of obtaining capital funds, but without the power to levy taxes. Their revenues are derived from tolls or service charges. Examples are the port authorities, bridge commissions, and different special district authorities established to provide and manage sewer, drainage, irrigation, and other services. These agencies are relatively powerless to increase their gross revenues, which depend on the volume of traffic or business done. The increased interest charges on the bonds issued by these agencies would materially delay amortization, and hence would delay the time when the tolls or charges could be reduced or eliminated. In some cases, at least, such a policy is regarded to be advantageous to the public, and in considering the future effects of the proposed extension of Federal taxation, the added delay in achieving this goal must be taken into account.

Summary of the position of the States and cities.—It is fair to say that the majority of the States, and also of the important counties and cities, have very little prospect of fiscal advantage from the suggested waiver of Federal tax immunity. The total State revenue from the taxation of Federal interest would be small in any case and it may vanish entirely under the social-security program. Such revenue as may be collected will be heavily concentrated in the few States in which the bulk of the individuals and corporations that own these bonds are domiciled. Elsewhere, the interest cost will greatly exceed the possible revenue gain. Even in the few States that may be regarded as fortunate from the standpoint of revenue gain, there is no assurance that all of the local subdivisions will find their budgetary problems eased by the tax change. These subdivisions must first obtain from their respective States a share of the new revenue, and they must then make certain that their own share counterbalances the increased cost of their loans. Finally, the non-income-tax States must decide between adding a State income tax to the load which the Federal Government is now placing on all incomes, and foregoing

[40] Tax delinquency varies also with general business conditions, and with the vigor of the collection administration. But in any given business condition, and with any given degree of vigor in collection, it is still true that the difficulty of collection tends to vary with the weight of the tax burden.

[41] Hardy, *op. cit.*, pp. 27, 39.

entirely any prospect of sharing in the meager total revenues that may be opened up to them.

Option III. Reciprocal Federal and State Taxation of Bond Interest, With Complete Removal of Federal Tax Exemption Privileges Now Accorded to Federal Bonds

The third option that is available for dealing with the tax-exemption problem is discontinuance of the practice of exempting the interest on Federal obligations from Federal income tax. This option can be exercised in combination with the other two, or it can be exercised alone. Since it involves the Federal Government only, it is a step which can be taken at any time by statutory change. No questions of constitutionality or of tax encroachment are involved.

The practical result of an elimination of the exemption now allowed to Federal interest, with respect both to the Federal revenue and the added interest cost, would be the same, whether this step were to be taken in combination with the changes which have been designated as options I and II, or as an independent act. Accordingly, the discussion will proceed with the estimates of revenue gain and added interest cost as if this were the only action to be taken relative to tax exemption. At the end of this section, these results will be combined with those obtained earlier. Thus two contrasting policies may be compared. One is the policy to be dealt with here, which involves the Federal Government only. The other is the policy of complete elimination of tax immunities and tax exemptions, which would be applied by a combination of the three options outlined.

1. *Federal revenue from the taxation of Federal interest.*—The revenue which the Federal Government would collect by subjecting the interest on its debt obligations to income tax naturally depends on the amount of interest and on its distribution among the categories of investors. Some of this interest is received by public funds and agencies, and some by institutional investors exempted from the income tax. While both of these groups are at present excluded, there is no guarantee that the policy will be maintained indefinitely. It was pointed out above that the absence of guarantee, especially for the State and local investment funds, gives particular emphasis to the importance of putting whatever policy may be considered upon a firm constitutional basis.[53] In this report, however, it is assumed that both the public agencies and the exempted institutional investors will continue to be excluded from the application of the Federal income tax.

(a) *The amount and distribution of Federal interest as of 1937.*—The total interest-bearing debt of the Federal Government and of its agencies in 1937 was $46,350 millions. On this debt the interest payment amounted for the year to $1,148,000,000.[53] It is necessary to resort to some assumptions at certain points in order to arrive at an allocation of this interest among the various categories of investors. Since the methods employed are rather technical, they will be presented in an appendix.[54] The apportionment of Federal interest, as of 1937, to the several investor classes, exempt and taxable, is shown in table XV.

Table XV.—*Estimated ownership distribution of Federal interest as of 1937, by categories of investors*

[Millions of dollars]

Category of ownership:	Amount
Public investment funds	$241.9
Exempted institutional investors	62.3
Subtotal, interest not subject to income tax	304.2
Corporations	565.0
Reported in 1936 by individuals with net income of $5,000 and over:	
Wholly exempt	42.5
Partially exempt	43.1
Reported in 1936 by individuals with no net income	1.3
Imputed to individuals with net incomes under $5,000	33.8
Imputed to individuals with net incomes of $5,000 and over	158.1
Subtotal, interest subject to income tax	843.8
Total Federal interest in 1937	1,148.0

[53] Supra, p. 124.
[53] Treasury Gray Book, pp. 11, 12.
[54] See appendix E.

(b) *The probable revenue yield from Federal taxation of Federal interest.*—It now remains to estimate the revenue which the Federal Government might expect from a volume of its own interest payments, to investors subject to income tax, as large as that shown in table XIV, and distributed to classes of investors in accordance with the assumptions indicated in the preparation of that table. The procedure followed here will be similar to that used earlier in estimating the yield of a Federal tax on State and local bond interest.[55]

(*i*) *The corporation tax.*—As indicated in appendix E, the corporation income tax returns for 1935 appear to warrant the assumption that on the average, only 60 percent of the interest received by corporations from their holdings of Federal bonds will be received by corporations having net income. On this basis, the Federal tax would have applied to $339,540,000 of the amount shown in table XV. Using a corporation tax rate of 16½ percent, the revenue would have been $56,024,000.

(*ii*) *The tax on individual incomes.*—It is necessary to deal separately with the several classes of interest income assumed to have been received by individuals.

First, the interest receipts in individual net incomes under $5,000 would be would be merged with the vast mass of net income in these low brackets. Since there is no way of knowing how many persons would be involved, and hence no way of knowing to just what extent deductions and allowances would enter, it is assumed that the highest effective tax rate on net incomes under $5,000 for 1936, namely 0.84 percent, would apply for 1937.[56] On this basis, the tax yield from this category of individual incomes would be $284,000.

Second, the partially-exempt interest reported, being already subject to surtax, would become subject only to the normal tax of 4 percent, as additional taxation, if the exemptions were removed. Disregarding any possible deductions or offsets, this part of the interest income of individuals would produce $1,726,000.

Third, there remains the wholly-exempt interest reported by individuals with net incomes of $5,000 and over, and the additional Federal interest deemed, for the present purpose, to have been received by this same group of taxpayers, a total of $200,600,000. As in the case of the Federal tax on State interest, the tax will be computed in two ways. One is to assume that the $200,600,000 of Federal interest which has been imputed to the individual incomes of $5,000 and over, consisting of $42,500,000 of wholly exempt interest reported in 1936 and $158,100,000 of additional interest imputed to these net income groups, is to be received by income groups in the same relative proportions as was the amount of partially exempt Federal interest reported in 1936. As explained above, the present distribution of Federal interest receipts which are subject to the whole weight of the Federal tax except for the small normal tax affords one clue to the possible distribution of the individual holdings and interest receipts when they are subjected to normal as well as surtax. The other method of calculation is to assume that with the removal of the exemption, the investment distribution pattern for Federal bonds would conform to that for bonds now taxable as revealed by the analysis of estate-tax returns.

Under the first method, which assumes that the entire amount of interest allocated to the larger individual incomes as of 1937 will be distributed through the several income brackets in the manner revealed by the reported receipts of partially exempt interest in 1936, the yield of the tax would be $45,661,000. Under the second method which assumes that the impact of the tax will lead to a distribution pattern for Federal bonds similar to that now found to exist for taxable private bonds, the yield of the tax would be $55,886,000.[57] An average of the two estimates would be $50,773,000.

The results of these estimates of the Federal revenue to be obtained from the complete removal of tax exemptions from all Federal interest are summarized in table XVI.

TABLE XVI. *Results of estimates of Federal revenue from taxation of Federal-bond interest, as of 1937*

Class of taxpayer:	
Corporations	$56,024,000
Individuals, with net incomes under $5,000	284,000
Partially exempt interest	1,726,000
Wholly exempt interest, in net incomes of $5,000 and over (average of two estimates)	50,773,000
Total estimated revenue	108,807,000

[55] Supra, pp. 120.
[56] Statistics of Income, 1936, p. 39.
[57] In appendix F the method of calculation is shown in detail.

In compiling the general results, the total, as shown in table XVI, will be rounded off to $109,000,000.

If may seem strange that the estimates of Federal revenue from a total Federal interest payment of $839,400,000 to investors liable to income tax should be less than the estimates given under option I of the Federal revenue from some $574,000,000 of State and local interest paid to taxable investors. The explanation lies in the different proportions found to have been received by corporations in the two cases. It was found that corporations received about 71 percent of all Federal interest that would have been taxable, as of 1937, and only about 35 percent of all State interest that would have been taxable in this year. Naturally, the less that is received by individuals subject to high surtaxes, the less must be the tax.

2. *Estimated increase of Federal interest cost.*—There is no reason to anticipate that investors will regard a removal of tax exemption from Federal interest any differently than they would a removal of tax immunity from State and local interest. That is, they will revalue the Federal debt paper on a basis which will throw as much as possible of the burden of the tax upon the debtor Government. The difficult element in the problem is to approximate the degree of readjustment of yield basis that may be expected to occur.

That there will be some readjustment of this sort seems clear. To hold otherwise would be equivalent to saying that there has never been any fiscal advantage to the Federal Government from the exemptions granted under the income tax. It would be equivalent to saying that the Federal Government could have sold its bonds and notes, through all the years since the war period, at exactly the same terms as they have been sold, whether the interest thereon were taxable or not. No one believes that such would have been, or could have been, the case. The Government has definitely benefited, through lower interest rates, from the tax exemptions granted.

It must be equally evident that a reversal of this tax policy would result in some readjustment of yield-basis rates, and that it would therefore cost the Government more, in interest, to carry a given volume of indebtedness than it now does. In discussing the effect of the Federal income tax on the yield basis of State and local bonds, in earlier pages of this report,[48] it was concluded, on the basis of such evidence as could be assembled from statistical sources and from the opinions of experts in the bond field, that the impact of the Federal tax would cause a readjustment of at least 60 points in yield basis for the long-term debt and of 20 points for the short-term debt of the States and their subdivisions.

The degree of readjustment, in the case of the yield basis for Federal debt obligations, will depend on the strength of the market demand for these obligations, and particularly on the comparative influence of corporate and individual investors, respectively, in establishing the market prices of the several issues. The burden of the Federal tax will not be the same for corporations as for individuals, taking the latter all together on an average basis of tax burden. A corporate owner of Federal securities would need to shift a tax which absorbs some 16½ to 19 percent of the income received, while the whole group of high-net-income individual investors must reckon on shifting a tax which would absorb, on the average, some 25 percent of the interest income received.[49] If the new yield basis were to be one which would allow complete shifting of the tax back to the Federal Government, it would require an adjustment of the present long-term yield basis, which is 2.40 percent, amounting to 16⅔ percent of 2.40, or 39.6 points, in the case of corporations, or of 25 percent of 2.40 or 60 points, in the case of individual investors. An average of the two requirements would be 50 points, which would mean a yield-basis rate of 2.90 percent for long-term Federal debt after the tax had been imposed, as against the present yield basis of 2.40 percent. The establishment of a 2.90 percent yield basis would mean, further, that the market competition between corporations and individuals had resulted in a shifting of part but not all of the tax burden falling on the general group of individual investors, and in the shifting of somewhat more than the full burden of the tax imposed on the corporate investors.

This is not an unreasonable or impossible outcome. The calculations just given as to yield basis change, if full shifting of the tax were to occur, indicate that corporations would need to buy taxable Federal bonds on approximately a 2.80 percent yield basis instead of a 2.40 percent basis, in order to realize about the same net return as at present. But they would not bid the prices to this level unless

[48] Supra, p. 110–112.

[49] Supra, p. 137. The results of estimates, presented there show that individuals with net incomes of $5,000 and over would pay total tax of $50,773,000 on a total Federal interest income of $200,600,000. This is an average tax rate of 25.3 percent.

other competing investors made it necessary. Their only competitors of consequence would be the individual investors, for whom, on the average, a yield basis of approximately 3 percent would be required to provide the same net return, after paying the tax, as is now received. But the fact that corporate buyers could afford to push the bidding for any given issue to a 2.80 percent basis, if necessary, would prevent individual investors from establishing a 3 percent yield basis. The actual price and yield basis levels would therefore tend to be a compromise which, when expressed as an average, would be 2.90 percent. Thus there is support, by deduction, for an average yield-basis change of 50 points in the interest cost of the long-term debt.

In the case of the short-term Federal debt, no definite yield basis data are available. This debt is in two main categories, namely, the Treasury bills and certificates, maturing ordinarily in about 90 days, and the Treasury notes, with maturities of 3 to 5 years. The interest terms and the yield basis of the Treasury bills have been extremely low. Since the investors who buy this paper are now receiving almost no interest income, the effect of a tax would be slight. To be sure, such interest income as is received would be subject to the same rates of tax as any other income, but the yield figure is already so near to zero that the impact of the tax would be negligible.[60] If the effect of the tax on the cost of issuing Treasury bills and certificates be entirely ignored, it would not materially affect the general result, as long as the current competitive situation for the marketing of the paper prevails.

The case is different with respect to the Treasury notes. The interest rates on these issues range from 1¼ to 1½ percent, and an average yield basis from 0.80 to 1 percent would probably be not far from the mark. Since corporate investors appear to dominate the market for the Treasury notes, the impact of the tax on corporate net income would be of greater controlling influence on the yield adjustment than that of the tax on individual investors. If the present yield basis for Treasury notes is from 0.80 to 1 percent, an adjustment of from 12 to 16.5 points would be required for complete shifting of the tax. A fair figure for use in the present calculation would be 10 points.

On the basis of the assumptions made here as to yield-basis changes, the effect of the Federal income tax on the cost of the Federal debt would be as set out in table XVII.

TABLE XVII.—*Estimated increase of interest on the Federal debt after subjection of that interest to Federal income tax*

Character of debt	Amount	Yield-basis adjustment	Increase of interest cost
		Points	
Long term	$28,512,000,000	50	$142,560,000
Short term:			
Notes	15,185,000,000	10	15,185,000
Bills	2,653,000,000	(1)	(1)
Total	46,350,000,000	.....	157,745,000

[1] As indicated in the text, no attempt is made to measure the impact of the tax on the cost of bill and certificate financing. While some adjustment might in fact occur, it would be so slight as to have only a negligible effect on the total cost of carrying the Federal debt. The item "Bills" also includes certificates.

SUMMARY OF OPTION III

Revenue gain to Federal Government	$109,000,000
Increased interest cost to Federal Government	157,000,000
Net loss to Federal Government	48,000,000

It comes as something of a shock to discover that the removal of the Federal tax exemption from Federal interest would cost more in additional interest on the Federal debt of $46,350,000,000 than it would produce in additional revenue. But this is not so unreasonable when the following facts are considered:

(1) Of the total Federal interest paid in 1937, $308,600,000, or almost 27 percent of the whole, went to exempted or immune classes of investors. Part of this

[60] In December 1938, Treasury bills were sold at a premium, which meant negative interest for the purchasers. This unusual situation was produced by the desire of the banks to effect certain advantageous year-end adjustments.

interest could be taxed by repealing the tax exemptions now allowed to philanthropy. The remainder can be taxed only by completely breaking down the tax immunity of the States for all of their institutional revenues. Should this be accomplished, it would enable the Federal Government to tax, not only the investment incomes of the States and cities, but also their incomes from waterworks, electric light, and power systems, and even their revenues in the form of taxes on property, gasoline, and other tax revenues.[41]

If the exempted Federal interest paid in 1937 had been taxed at the corporation rate of 16½ percent, the yield would have been $50,900,000, or about enough to balance out the gain and loss as shown by the above summary.

(2) More than half of the entire Federal debt is held by corporations.[42] Taking into account the degree to which corporate tax liability is affected by business conditions, and the rates applicable to corporate net incomes, it is clear that the revenue possibilities in this direction are not large. In fact, reference to table XV [43] discloses that individuals with large incomes do not receive a large portion of the taxable Federal interest.

SUMMARY OF OPTIONS I, II, AND III

The fiscal results of the examination of the several possibilities for dealing with tax exemption and tax immunity will now be brought together, singly and in combination. All figures are in millions of dollars.

Option I (from p. 122 above)

States:		Federal Government:	(a)	(b)	(c)
Loss	113	Gain	120	70	95

Option II (from p. 125 above)

States:		Federal Government:	
Gain	17	Loss	30

Option III (from p. 139 above)

Federal Government:	
Gain	109
Loss	157
Net loss	48

Combination of the three options

STATES

Gain: Tax on Federal interest	17
Loss: Federal tax on State interest	113
Net loss to States	96

FEDERAL GOVERNMENT

Gain:		Loss: Increased interest cost:	
From tax on State interest:			
(a)	120	By State tax	30
(b)	70	By Federal tax	157
(c)	95		
From tax on Federal interest	109	Total Federal loss	187

Total Federal gains: (a) 229, (b) 179, (c) 204.
Net gain (or loss) to Federal Government:

Under estimate (a) of option I	42 gain.
Under estimate (b) of option I	8 loss.
Under estimate (c) of option I	17 gain.

[41] Supra, p. 115, note.
[42] See Appendix E.
[43] Supra, p. 136.

Balance of State and Federal gains or losses:

Under estimate (*a*), a combined net loss of 54 (excess of State net loss over Federal net gain).

Under estimate (*b*), a combined net loss of 104 (sum of State and Federal net losses).

Under estimate (*c*) a combined net loss of 79 (excess of State net loss over Federal net gain).

In short, the outlook for net fiscal advantage from any sort of change in the tax exemption situation is not particularly attractive. The combined balances of gain and loss that emerge from the calculations offered here indicate varying amounts of net loss, depending on the estimates that are used as the probable Federal revenue from State and local bond interest. It seems that one source of this net loss is the fact that a considerable proportion of State and Federal interest, respectively, is being received by agencies and institutions which are excluded from the Federal income tax. It is probable that if this interest were to be taxed, there would be a fairly close balance of the gains and losses.[64]

After all, some such result is what might be expected from a deductive approach to the problem, if it be assumed that those who were made subject to a tax, from which they had hitherto been immune, would make an effort to shift it. The continuing presence of a field of tax exemption, over against the remainder of the investment field for which there is no exemption, tends to create a differential in favor of the tax-free investments. Withdrawal of the tax preference would tend to wipe out this differential, not so much by causing the acceptable rate of investment return in the taxable field to drop to the level of that which had proved to be acceptable in the tax-free field, but by the reverse process of causing the yield basis in the formerly exempt field to rise to a level approximating that in the investment area which had always been subjected to taxation. Such differential as would continue when both investment fields were taxed on the same basis would be attributable to whatever superiority, from the standpoint of security of principal, certainty of return, and effectiveness of the processes available for enforcing payment, that the investments in one field might still present over those in the other field.

In the estimate presented here, no assumption has been made to the effect that with the removal of tax exemption, the yield basis of Government securities will completely coincide with that of the best private securities. It has been assumed that this spread will be reduced, and such approximations as have been offered here have been based upon calculations, intended to be reasonable and probable, of the influence of the tax exemption in causing this spread, and therefore of the influence of removing the exemption upon its diminution.

The effect of the social-security program which is now in operation upon the whole future of the exempt security problem must be mentioned again. The foregoing summary of the results that may develop under the several available options presents the situation as it may exist some 30 to 40 years hence. If the present plans for a large old-age reserve fund are carried out, they will also require some 40 years for their complete development. Consequently, the situation which may exist, say, in 1980, is that a Federal agency, namely, the old-age reserve account, may be the sole holder of Federal debt. The practical result of whatever taxation changes might be made would be, therefore, Federal taxation of State and local bond interest with no counterbalancing taxation or adjustment of any kind. In other words, the practical result would be that outlined under option I.

This would be the case, regardless of the manner in which the tax changes are to be made, whether by statute or by constitutional amendment, and regardless of the guaranties which might be held out to the States with respect to reciprocal taxing powers. If no Federal debt is to be held by any investor subject to a State or a Federal income-tax law, all guaranties and all waivers of immunity will have no significance.

As a practical fiscal matter, the wisest procedure would be to neglect entirely all of the elaborate calculations that are made here, or that anyone else may make, relative to options II and III, or any modification of these options, and concentrate attention upon the effects that are likely to be produced under a future tax situation which would be the equivalent of that outlined under option I. Unless the financing provisions of the Social Security Act are profoundly modified, there is little use to consider any other fiscal situation resulting from the removal of tax

[64] In a much more elaborate study of the subject than is here undertaken, Dr. O. O. Hardy came to the conclusion, some years ago that the revenue gains and interest costs would about equal each other. Cf., O. O. Hardy, tax-exempt securities and the surtax (1926), pp. 99, 100.

immunity or tax exemption. For this reason it is particularly important that the States have ample time and opportunity to consider just where they are likely to come out, as a result of any changes that are to be made.

PART II. THE GENERAL ECONOMIC AND SOCIAL ASPECTS OF TAX IMMUNITY AND TAX EXEMPTION

SUMMARY

This section of the report deals with the general economic and social aspects of the taxation or exemption of public securities, with particular reference to the problem of intergovernmental relationships. The Federal Government is privileged to tax or exempt its own securities without giving rise to the issues that are precipitated by the relations between State and Federal Government. Much of the discussion about this subject has implied, however, that State and local securities constitute the villain in the play. Yet, because of the many points of uncertainty with respect to the rights of the States and the limitations to be imposed on any extension of Federal taxing power, there is no reason whatever for refusing to proceed with sufficient caution and deliberation to make certain that an equitable adjustment of these difficulties is proposed in advance. The only way of doing this is by consideration of a constitutional amendment. It cannot be done merely by a statutory change.

As a preliminary to the discussion of appropriate amendments, it is proper to examine the case that is advanced to demonstrate that some sort of action should be taken. This part of the present report is devoted to an examination of the so-called "tax-exemption evil" from various viewpoints. The preceding part of the report has indicated that the fiscal results are inconclusive, except to indicate that more is likely to be lost than gained, from the standpoint of all taxpayers. It now remains to consider what are the grounds for insisting upon a program that will inflict these net losses, because of the other advantages and improvements that will ensue.

(1) The leading argument for the elimination of tax exemption and tax immunity is that this must be done in the interest of progressive taxation. The tax-free bond is said to be a form of investment which makes it easy for investors to avoid the payment of heavy surtax, or indeed to avoid the payment of all income tax. Two issues emerge here, one relating to the ease of tax avoidance, and the other to the paramount importance of progressive taxation.

(a) *The ease of tax avoidance through the tax free security.*—The tax exemption problem must be whittled down to its proper size, by eliminating all of the Federal and State interest except that which is received by the few individuals with large incomes. Other investors are accepting a yield on investments of this character, which offsets, or more than offsets, the tax that they would pay if taxable securities were owned instead. While these investors do not, in fact, contribute to the Federal Government, they are contributing as much or more to the relief of other taxpayers as they would otherwise contribute in Federal tax. Since all grades of government must be supported, there is no real case of easy tax avoidance with respect to a large proportion of the interest paid on the public debts.

The breaking point of advantage in taxation through ownership of tax-free securities depends on the yield basis level and on the spread between the yields on exempt and taxable investment. Under the conditions prevalent through much of the year 1938, and with the tax rates then applicable, this breaking point would come at an income level of some $55,000 to $60,000. It is only above some such income level that the investor begins to gain through ownership of the tax-free security.

No definite information exists as to how many persons are involved, above this level, through the ownership of tax-free securities, or how much tax-free income is involved. Even more uncertain is the question of how much of this income would remain in the high-income brackets for taxation if the policy were changed. In 1936 there were 12,975 individual returns of $60,000 net income and over. These returns reported a total net income of $1,595,000,000, and a total tax of some $651,000,000 was levied upon that income. In any event, the persons who could benefit from the ownership of tax-free securities have not sought complete escape from Federal income tax in the haven of the tax exempts. All of the evidence indicates that the ownership of tax-free securities is, in the main, incidental. It is not a road to wealth. Those with large estates acquire some of these securities, but in general the progressive income-tax system remains intact. It has not been destroyed, or even seriously impaired, through these investments.

Even so, it would be worth considering what might be done, if only the effects of the tax policy could be confined to the few persons who do escape some part of their tax. This raises the question of the relative emphasis upon tax progression, as against other considerations, for the subjection of all persons to strict progression may have other consequences that ought to be considered.

(b) *The case for progressive taxation.*—The primary purpose of all taxation is to provide public revenue, but the incidental and collateral effects of the revenue system must not be ignored. In fact, the Congress has already modified the progressive principle, in recognition of these collateral effects.

One case of modified tax progression is in the treatment of long-term capital gains, which may be realized without subjection to the complete and rigorous scale of surtax rates. Another case is the deduction for charitable contributions up to 15 percent of the net income. At bottom, the justification for each of these modifications is that the public revenue benefits ultimately, through the recognition of public interests other than those of a hypothetically just system of taxation. A freer capital market will contribute eventually to larger national income, and thus to larger revenues. Hence, it is wise to moderate the tax on capital gains in the interest of free capital transfers. Gifts to education and philanthropy mean that the State must spend less on these services, and thus the exemption of such gifts results in savings to other taxpayers.

So it is with the tax-free securities. Investors, through their competition, establish a lower interest-cost level for these securities, and thus save other taxpayers from costs that they would otherwise pay. The fundamental issue here is whether it is more advantageous that the millions of these other taxpayers should have such relief as is thus afforded, or that the very few persons for whom the tax-free security does represent a saving should be brought strictly to book.

The modern income-tax policy has overemphasized progression under a mistaken impression that by so doing the principle of ability to pay was being served.

(2) A second argument for the elimination of the tax-free security is that it diverts funds from productive private investment. Literally, there is a diversion, since the same money cannot be simultaneously invested in municipal and in corporate bonds. Practically, the issue is whether the growth of public debts, and particularly of State and local debts, has been a hindrance to the growth of private capital.

The greater part of the State and local debt now outstanding was issued during the twenties. All of the evidence that is available indicates that this was also a period of rapid business expansion. Those who believe that the collapse in 1929 was caused by overinvestment would probably argue that there should have been a greater diversion from industry than in fact occurred. Moreover, the Federal Government was paying off its debt at a substantial rate from 1920 to 1930, and much of what the States and cities borrowed may be regarded as simply an absorption of the funds released by Federal debt payment. There has been very little net increase of State and local debt since 1932, and also very little addition to the capital fund. The fact is that in prosperous times the Nation's productivity can support both industrial growth and the expansion of public services, but in depressed times, it can support neither on the accustomed scale.

(3) A third argument is that much State and local borrowing has been wasteful, and elimination of the tax immunity would curb local extravagance. Reference to the purposes of State and local debt issue indicates that it has been incurred in the provision of facilities and the performance of services that were demanded by the people, or by the forces of social change, such as the motor vehicle and the need of improved highways. Very little of this debt has been issued to pay for current operating expenses.

In weighing the relative advantages of strict taxation and of the incidental benefits to the millions of taxpayers who now support State and local government, the future must be considered, for it is quite likely to bring new problems, in the solution of which further use of public credit will be required. An example of these future needs is provided by the program for low-cost housing. An examination of the National Housing Act of 1937 reveals that it is filled with conditions and assumptions of tax exemption. It is indeed strange to find certain departments of the Federal Government pressing so zealously for the elimination of all tax exemptions and immunities, while at almost the same time the Congress is passing new and forward-looking legislation, the very success of which rests upon extensive use of the lower rates of interest to be obtained through tax exemption. New York officials estimate that the removal of tax immunity from housing-authority bonds will add as much as $1 per month per room to the rentals which they must obtain. This would be a definite blow to the goal of low-rent housing,

unless it is intended that other State and local taxpayers shall be called upon to supply a subsidy that will offset this increase.

The main object of this report is to set out all of the principal issues that are involved in the problem of inter-governmental tax immunity. If it appears to stress those elements of the problem which reflect the State and local viewpoint, it is because no one has as yet undertaken to set forth such arguments and considerations as should be examined in arriving at a matured judgment.

One of the most fundamental of all considerations is that action should be taken in such manner as will preserve the Federal experiment and promote its lasting success. The Supreme Court has often been criticized for its tendency to modify the Constitution through judicial construction. Yet, here is a case in which the Department of Justice and Treasury rely upon judicial elimination of a doctrine, more than a century old, for the purpose of obtaining a further extension of the Federal taxing power. If, after weighing everything that can be brought out on both sides, the people should decide that it is better for the millions of small taxpayers to have their burdens increased than it is for a few hundreds or a few thousands of investors to escape Federal income tax on a small part of their incomes, then the only right and proper procedure is to formulate and submit to the States a constitutional amendment, under which Federal and State taxing powers shall be carefully stated, and as carefully limited, to accomplish the purposes desired.

The General Economic and Social Aspects of Tax Immunity and Tax Exemption

Since no clear-cut case exists, in terms of dollars and cents, for extending the Federal taxing power to the interest on State and local bonds, it becomes necessary to consider what reasons, other than those of a financial sort, might be advanced in support of such a change. These reasons will be reviewed here. The discussion of this aspect of the subject will be directed chiefly at the Federal-State relationship and the implications that arise from the proposed elimination of the immunity rules. The grounds for this delimination are the following:

First, the States are directly affected by and concerned with the proposal to extend the Federal taxing jurisdiction to the interest on their bonds. They are not directly concerned with anything that may be done with respect to the taxation status under Federal laws, of interest on the Federal bonds.

Second, it is the State aspect of the problem which gives rise to controversial issues of authority, legal and constitutional. No such issues can arise with respect to the Federal tax policy toward Federal interest.

Since a grant of authority to tax State instrumentalities in a manner that will affect the terms and conditions of their use by the States, will directly influence, and possibly interfere with, the performance of State functions, the reasons that are advanced in support of such a grant become of the greatest importance. The relations of Federal and State Governments will be profoundly affected by it, whether the extension of Federal power be made by a statute which would become permanent if it were sustained by the Supreme Court, or by constitutional amendment. The question of procedure in such an important matter admits of only one reasonable answer, which is that such change as must be made, if any, should be by amendment. There are far too many points of uncertainty, and far too many hazards involved for the States, to warrant their passive acceptance of a mere legislative extension of Federal power.

While the amendment process would presumably assure certain essential guarantees to the States and would set limits to Federal taxation which would protect their own governmental revenues from such taxation, the suggestion for an amendment does not go to the root of the matter. It is necessary, first of all, to discover what sort of case can be made for the proposed expansion of the Federal taxing power. The results of an examination of the project from the fiscal side are quite inconclusive, except to indicate that more is likely to be lost than gained, from the standpoint of all taxpayers.

The Arguments for the Elimination of Tax Immunity and Tax Exemption

1. *The argument that tax immunity and tax exemption must be eliminated in the interest of progressive taxation.*—There is only one argument of importance which has been advanced in support of the proposed extension of the Federal Taxing power. This is the argument that tax immunity and exemption must be eliminated in order to make progressive taxation operate with mathematical precision. The policy of exempting the interest on Federal bonds was introduced during the war, as one plank in the program of selling the war bonds at lower rates of interest

than would have been possible otherwise. Naturally, the interest on State and local bonds has been considered immune from Federal taxation since the beginning of the income tax in 1913. As the surtax rates were increased, the advantage of owning a tax-free bond became greater for the recipient of a large income. This advantage has been offset in part by the premiums which the highest grade tax-exempt bonds commanded and by the decline of coupon rates on such bonds. The discussion of the subject has been characterized by many generalities which were not, and in some cases could not be, substantiated. The principal emphasis in that discussion has been upon the extent to which the policy has undermined the income tax.

A recent representative expression of this viewpoint occurs in the address by Dr. Roswell Magill before the National Tax Association in 1937. He said: [45]

"Progressive surtaxes cannot be made to operate effectively so long as governments themselves provide this easy mode of escape for them."

The implication of this and many similar statements is that the whole Federal income-tax system has been broken down by the existence of the tax-exempt securities, and also that there is here provided an "easy," that is, an entirely painless or burdenless way of evading income tax.

Two separate contentions or arguments are implied here. One is that the strict application of progression is always paramount to every other issue in taxation. This will be dealt with below. The other contention, to be discussed immediately, is that the presence of tax-exempt securities provides an easy escape from progression.

(a) *Scope of tax immunity and tax exemption as a fiscal and economic problem.*—Before it is possible to proceed with the argument that tax immunity and tax exemption constitute a serious menace to the operation of the income tax, it is necessary to see more definitely the dimensions of the problem. In all of the popular discussion, and in some which has been contributed by responsible persons, this matter of the alleged escape from the full effects of progressive taxation has been set forth as if it were coextensive with the whole volume of public debt obligations. Since the total of Federal, State, and local debt, as of 1937, was some $65,000,000,000, it is implied that the escape of wealthy individuals from the progressive income tax is of a similar relative order of magnitude. That is, it is implied that all of the interest paid on this huge debt, amounting to some $1,951,000,000 in 1937, was received by persons who should have been paying substantial rates of progressive taxation. Carelessness in defining the real problem has been responsible for much of the unrest and discontent that are said to have been provoked by the existence of tax-exempt or tax-immune securities.[46]

The figures that have been given in part I indicate clearly that the real problem of escape from income tax is of considerably smaller dimensions than would be indicated either by the principal of or the interest on the public debts. Thus, there is no question of progressive taxation involved in the interest that is received by the public trust and investment funds on their holdings of public debt. Nor does this question enter in the case of the exempted philanthropic institutions or the ordinary business corporations. In fact, it is only that part of this interest which would be received by individuals with large incomes that does involve the issue of "tax justice," or progressive taxation.

It is impossible to ascertain just how large a proportion of the exempt and immune interest is being received by the individuals with large incomes. These persons make certain informational reports, in connection with their income-tax returns. Except for the partially exempt Federal interest there is no tax liability and hence no enforced obligation to make a complete return. For the year 1936 the individuals with net incomes of $5,000 and over admitted receipt of State and Federal interest as follows:

Interest on State and local debt	$182, 793, 000
Interest on Federal debt:	
Wholly exempt	42, 619, 000
Partially exempt	43, 152, 000
Total	268, 564, 000

[45] National Tax Association, loc. cit. Cf., also, Facing the Tax Problem, published by the Twentieth Century Fund, 1937, pp. 303-306, for a 1-sided discussion of the tax-exemption problem, in which little attention is given to any other phases of the matter except the lapse from "tax justice" which is involved in the escape of certain portions of certain large incomes from the strict application of the progressive tax scale.

[46] It should be said that the Treasury Department has compiled data which help to correct this impression. They have been issued in temporary form, and have been used freely in this report, the citation used here being to the Treasury Gray Book. Supra, p. 100.

[47] Supra, p 119.

For reasons that are set out in part I,[67] it was not possible to accept these figures as an accurate reporting of the wholly exempt interest from Federal and State debt obligations. In tables VI and XV, the following amounts of State and Federal interest were imputed to individuals with net incomes of $5,000 and over:[68]

State and local bond interest	$348, 900, 000
Federal interest	195, 800, 000
Total	544, 700, 000

This is a substantial amount, but the caution was noted as the figures were offered that complete accuracy was not claimed for them. The error, if any, is that they overstate the amount of interest income received by this particular group of taxpayers. The correct amount of interest received as of 1937 by individual investors was probably somewhere between the lower limit of the total actually reported in 1936 and the upper limit of the receipts imputed to them in this report.

But not all of such tax exempt interest as may actually be received by the individuals with net incomes of $5,000 and over is involved in the real problem of progressive taxation.

None of it is taxed, to be sure, but the recipients of a substantial portion of it are paying a heavier price for the receipt of a tax-exempt income than they would pay for the ownership of taxable bonds. That is, they are out of pocket more, in consequence of the low yield of the public securities, even if no income tax is paid, than they would be if they had bought taxable bonds and paid the tax. For all such persons, the exempt security does not provide an "easy" escape from income tax, but a relatively hard way.

In effect, the acceptance of a lower-yield rate on a tax-exempt investment is a kind of taxation at the source. Part of what would otherwise be income is taken from the investor who buys a tax-exempt bond in the form of a lower rate of interest than would be payable if the return were subject to income tax. The investor in State or local bonds is not contributing directly to the Federal Government, but he is contributing handsomely to the support of State and local government. In fact, he is doing more toward the tax relief of those who must support State and local government than he would do if the tax immunity were removed. Since the citizens of the States and the citizens of the United States are, after all, the same body of persons, does it really matter so much whether the contribution which each one makes in support of government is made to the Federal, or to the State government? It is possible to be over-zealous in looking out for the taxing authority and the taxation interests of one government, to the neglect of the interests of the other governments in the Federal system.

If the investor buys Federal tax-exempt bonds, he is contributing indirectly to the support of the Federal Government, through a kind of withholding from his income at the source. The figures given in part I show that the indirect contribution of all investors is greater, in the aggregate, through their acceptance of lower interest returns than it would be if the tax exemption were removed.[69]

Looking at the matter, however, directly from the standpoint of the portion of the tax-exempt and tax-immune interest that is received by persons who gain more through such investments than they would by owning taxable investments and paying taxes, it is evident that the positive advantage appears only at a certain level of income. In fact, it may be rather surprising to some to find that the breaking point between advantage and disadvantage in the ownership of tax-free securities lies as high as it does in the income scale. Its exact location will depend on the yield spread between the exempt and the taxable securities.

This point can be illustrated as follows. According to the investment yield figures given in appendix B, the average yield basis for high-grade municipals during 1938 was 2.60 percent and for triple A corporate bonds it was 3.20 percent. If during 1938 one had had the choice of buying either municipal or corporate bonds on these respective yield bases, the result, from the income and taxation standpoint, would have been as follows. It is assumed that the purchaser is married, without dependents, and that no other deductions are made from income except for marital status. It is also assumed that he has no other income, although this is done only to simplify the illustration.

[67] Supra, p. 119, for table VI, and p. 136 for table XV.
[68] *Cf.* the summary of Option III, supra, p. 139.

Amount invested	Excess of income from corporate bonds	Income tax	Gain, after taxes, through purchase of taxable bonds
$1,000	$6	None	$6
$10,000	60	None	60
$100,000	600	$28	572
$1,000,000	6,000	4,085	1,915
$1,700,000	10,200	10,365	[1] 165

[1] Loss.

The breaking point rises as the yield spread widens. With a municipal bond yield of 2.60 percent, and a corporate bond yield of 3.35 percent, or a spread of 75 points, the positive advantage from acquisition of tax exempt securities would begin at just under an investment of $2,000,000, or an income of $67,000.[70]

If the investor has other income, his calculation of the advantage or disadvantage from the purchase of tax-exempt securities would naturally take into account the taxes to be paid on that other income, but the above figures indicate that there is no tax advantage from converting his estate into exempt securities until after the income has passed the level of $54,000 or thereabouts, if the yield bases and differential are as they were, on the average, during 1938; or the level of $67,000 or thereabouts, if the yield spread should be as much as 75 points in favor of the corporate bonds on a 2.60 percent basis for the municipal bonds.

Consequently, the undeserved escape from progression is a matter which should give rise to concern only in the case of those with net income above the level of some $50,000 to $60,000. Below that level, the advantage from tax-exemption which may accrue to any taxpayer if he has other income is not of great relative importance. It is impossible for anyone to say just how much of the total tax exempt and tax immune interest is now being paid to individuals with a net income of $60,000 and more. If this amount could be ascertained with any certainty, it would be possible to get a definitive measure of the tax loss which is correctly attributable to the defective operation of the progressive system. As has just been pointed out, the inapplicability of the progressive income tax below the $60,000 level or thereabouts is a matter of no concern in the present connection, for the investor is giving up, in income, more than he would were he subject to income tax.

Even if it were possible, however, to ascertain exactly how much interest income is being received in the income brackets above $60,000 it would be quite another matter to do something about it in a manner which would confine the effects simply to the few persons involved. If the action were to be taken along the line of eliminating the tax exemption or immunity, the bad effects on a large number of other taxpayers would offset the supposedly just results obtained in a few cases.

Here is the practical, as distinguished from the abstract and theoretical, aspect of this problem. The benefits of the present system of tax immunity and tax exemption are not confined to a few wealthy individuals. They are shared by all taxpayers in the form of lower taxes to support the public debt. If the claims of a vague and abstract tax justice are made paramount, the increased tax burden cannot be restricted to a few wealthy individuals. It also will fall on all of the other taxpayers.

The charges that have been made relative to the evils of tax exemption carry implications that are not sustained by the available evidence. The implication is that wealthy individuals are more concerned with an escape from heavy income taxation than with anything else. If this were correct, then there should be an extreme concentration of the exempt and immune securities in the large estates, and the owners of these estates should have divested themselves of all other investments in order to buy these tax-free investments.

There is no evidence to sustain the implication that the tax-free securities are all owned by wealthy individuals, or to support the suggestion that these persons prefer such investments above all others. Since the privilege is worth more to them than to corporations or small investors, they could easily enough acquire the outstanding supply if they chose to embark on this kind of investment policy, as they could afford to outbid everyone else for them.

[70] On the bases assumed, the excess of income from the corporate bonds would be $15,000. The total income from the corporate bonds is $67,000, and the tax on $64,500 ($67,000 less personal credit of $2,500) is $15,215.

The few wealthy individuals have not, in fact, pursued such a course. The estate tax data summarized in appendix D reveal an upward movement of the ratio of tax-free bonds to gross estates as the size of the estate increases, but on the average the proportion of such investments is always far below the proportion of corporation stocks held. While there doubtless are individual instances of large estates which are invested entirely in tax-free bonds, the general or over-all picture is quite different in its emphasis. In fact, the estate tax data support a viewpoint which is suggested by common knowledge and observation, to the effect that the purchase of tax-free securities is not what makes one wealthy. Rather, the situation is that as one's wealth increases, there is a tendency to invest some part of it in securities of this sort, partly for reasons of tax relief and partly for other reasons. The basic source of wealth and income is the country's productive industry, and the persons who own considerable wealth indicate very clearly their strong preference for ownership of the forms of property right which grew out of, and rest upon, the economic pursuits of the community.

In addition to the evidence of the estate-tax data, which is so clearly against the notion that the wealthy over-stress tax evasion, there is also the evidence of the income-tax statistics. This evidence, it should be said, constitutes one answer to the charge that the very wealthy individuals are escaping the operation of the income tax through the avenue of the tax-free securities. It is worth while to see just what the tax situation is in the upper-income brackets.

According to the Statistics of Income for 1936, there were 12,975 returns of net incomes in the brackets of $60,000 and over, which was 0.24 percent of the total number of returns filed. The total net income reported in the returns of $60,000 and over, in 1936, was $1,594,589,000.[71] This was taxable net income. Evidently those persons for whom escape from progression was easy did not regard the tax-exempt field as sufficiently important or attractive to warrant them in deserting the business and industrial investment field simply to gain refuge from progressive taxation in the haven of the tax exempts.

Further, the 12,975 persons who made a net income return of $60,000 and over in 1936 were assessed to pay, on the face of their return and prior to audit, a total income tax of $650,869,000. This was an average tax per return of $50,163, as compared with an average tax per return of $104 on all persons with net incomes below the $60,000 level. The tax paid on incomes above $60,000 represented 40.8 percent of the net income reported, while the tax paid on incomes below $60,000 represented 3.19 percent of total net income in those brackets. Despite the omission of comparatively small amounts of exempt or immune bond interest, there is still plenty of progression in the income tax, according to these figures.

When there is other income, the breaking point of advantage in holding tax-exempt securities may drop to the net income level of $20,000 or thereabouts, although the exact point will depend on the relative yield of exempt and taxable investments. As indicated above, the relative gain from such investments by persons whose net income may be between $20,000 and $50,000 is not large and it becomes smaller in proportion as the income itself diminishes. In 1936 there were 84,565 persons who reported a net income of $20,000 and over. The total net income reported by these persons was $3,847,219,000 and the tax levied thereon was $949,276,000.

Opinions will differ as to whether the presence of as much income from tax-exempt sources as may be received, either by those in the net income brackets of $60,000 and above, or by the somewhat larger group in the net income brackets of $20,000 and above, means so great a degree of failure in the application of progression to all incomes as to constitute a break-down of the progressive principle. So far as concerns relative magnitudes, it does not make a very strong case for the collapse of the progressive policy, either with respect to the number of taxpayers involved, or with respect to the proportion of the total net income in these higher brackets. Much depends upon the weight that is allowed to some other factors in the situation. The principal other factor is the effect on taxpayers in general that will be produced by the higher cost of the debt, once the tax policy has been changed.

Finally, the loss of revenue is, in considerable degree, apparent rather than real. Any estimate of a large revenue loss must be based on the assumption that the individuals with net incomes above, say, $50,000, will continue to hold public bonds, after the tax is imposed, in the same amounts as they are now supposed to hold them. Such an assumption is only wishful thinking. If the present holders should make extensive readjustments, the potential revenue will shrink rapidly. Moreover, without the market demand such as is now supplied by this group,

[71] Op. cit., p. 88.

interest rates would be even higher because of the inability and the disinclination of small investors to absorb large quantities of these securities except at attractive rates of return.

Thus, the service of the large investors in keeping down interest costs is a real service, while the Government's revenue loss caused by the exemption of their holdings is, in considerable measure, a paper or hypothetical loss.

Some exceptions to the progressive principle.—From a practical rather than an abstract standpoint, it should be clear that a policy of taxation must be so shaped as to obtain the necessary public revenue in the manner that will best serve the general public interest, and that the requirements of public interest are at times to be put ahead of strictly theoretical considerations.

Rigid and unvarying enforcement of progression is one of these theoretical principles. It is a goal which may be sought, provided there are no other sufficiently important considerations of public advantage that should come first. It is necessarily a theoretical goal, for no one can prove the absolute superiority of one scale of progressive rates over any other scale. The present income-tax law contains some instances of the recognition of regard for the public interest, a regard which has led to relaxation of the strict progressive principle at certain points.

(i) *Strict progression waived for capital gains.*—For many years the Federal income tax law has mitigated, by one device or another, the full rigor of the progressive scale in the case of capital gains, especially the long-term gains. These gains have not been included, to their full extent, as taxable income. Obviously, in whatever degree or by whatever device, the amount of such gain is scaled down for tax purposes, it constitutes an abandonment of unflinching progression. This policy has been adopted because it was generally agreed that the current tax rates would be a serious hindrance to the free transfer of capital assets, and because it was generally agreed that a free capital market was more in the public interest than the claims of abstract tax justice. It was deliberately introduced to further certain definite ends, notwithstanding the fact that it constitutes a clear and deliberate interruption of the principle of progression in the higher income brackets whenever capital gains may be realized. In making this change the Congress very properly decided not to let blind adherence to a fixed idea of taxation stand in the way of modifications which seemed to be in the best interest, not only of the public but of the revenue.

(ii) *The case of charitable contributions.*—At another point, also, the income tax law has always disregarded strict progression. This is the provision which authorizes deduction of 15 percent of net income for gifts to education and philanthropy. It means that those with large incomes are not held to strict account for a progressive tax on their entire net incomes. It is clear recognition of the proposition that the public interest is broad enough to embrace other matters than rigorous and unflinching taxation at progressive rates. There is a definite revenue loss involved in this concession, too, but the gains at other points in the economy, including the indirect revenue gains, are deemed to be worth more than this loss.[77]

(iii) *The immunity of State and local bonds also involves the public interest.*—In the case of the immunity of the interest on State and local bonds from Federal taxation, another issue of relative gains and losses is presented, which is simply another way of saying that here, also, is a matter which touches and involves the public interest. It has been shown in part I that the interest costs to the States would be increased by about as much as Federal Government could expect to to gain in revenue from taxing that interest. But it also appears that a few thousand persons who happen to own some of these immune bonds, though by no means all of them, are not being taxed on the interest thereform at the rate to which the progressive scale rises under the Federal income tax. The hue and cry has been raised that here are some tax evaders who should be brought to book and made to pay in full. If this be done, it may produce some additional Federal revenue and the theroretical requirements of the progressive system will be more fully satisfied. But it will also mean an increase of State and local taxes on the many millions of persons with small properties and small incomes who are now carrying the heavy load of State and local taxation. It will add about as much to their tax burdens as will be collected from the few who have bought the bonds of the States and their subdivisions.

[77] In 1936, individuals reported total contributions of $385,833,000. Statistics of Income, 1936, part I, p. 100. The total state and local interest imputed to individuals with net incomes of $5,000 and over, as of 1937, was $337,400,000. *Cf.* table VI, p. 119, *supra*.

This relative increase of the tax load at the bottom of the tax scale is a kind of regressive taxation. Now the one thing which the ardent devotee of progressive taxation abhors above all else is regressive taxation. Yet in this case he faces the paradox of causing increased regression in one place by insisting upon the strict application of progression in another place.

Incidentally, this paradoxical result has been more widespread than may have been realized. The comparative futility of State income taxation was pointed out in part I. One reason for this result is the extent to which the Federal income tax, with its extremely high rate scale, has monopolized the income tax field. In consequence, the States have been driven to develop other revenues which are regressive in relation to incomes. The advocate of progression at all costs has overlooked the vicious circle thus created, for the growth of regressive State taxes, being stimulated by the Federal income tax policy, leads to a demand for more severe progression which in turn compels more intensive regression, and so on.

This issue of the immunity of State and local bond interest involves the public welfare in a degree which transcends such questions as the supremacy of the Federal taxing power and the fiscal gain or loss to either Government. It involves the integrity, the independence, and the service responsibilities of the States under the Federal system. Unless clear and definite limits are set to any such extension of the Federal taxing power as is here contemplated, the financial freedom and independence of the States are in jeopardy.

The argument in the study published by the Department of Justice is intended to show that the sixteenth amendment gave Congress an unlimited and unrestricted power to tax income from whatever source derived.[71] But the net revenue of a city waterworks system is income, and the receipts of a public trust fund are income. If the sixteenth amendment is to be construed as the Department of Justice contends, it must apply to such income, for the position is that this is an unconditional and unlimited grant of power to tax income. Unless the rights of the States are definitely clarified and established, it is entirely possible that this interpretation of the Federal taxing power would lead, before too long, to a Federal tax on all State and local revenues. This, it is submitted, is a matter of the public interest which is superior to any questions regarding the operation of the progressive income tax.

(b) *Progressive taxation and ability to pay.*—The principal reason for the insistence on progressive taxation is that it is supposed to be the only correct method of imposing taxation according to ability to pay. The concept of ability has never been precisely defined, and this vagueness has no doubt contributed to its widespread acceptance, since each one could give to it such meaning as best suited his own convenience or special interest. It has also contributed, beyond doubt, to the transfer of emphasis from ability to progression, as if the two ideas were equivalent and interchangeable. In consequence, the importance of progression has been exaggerated. It, rather than ability, has come to be accepted as the really significant thing. Progression has come to be regarded as a kind of eleventh commandment, the one and only test that some persons are willing to apply in passing judgment upon either a tax or a tax system.

In the writer's opinion, an extreme emphasis upon progression is not necessary to bring income taxation into line with ability to pay. On the contrary, an exaggerated emphasis may produce the opposite result. The reasons for this position are as follows:

(1) The policy of progression requires, for administrative reasons, that all income be summarized at the end of a period, usually a year. It would be administratively impossible to tax separate items of income receipts, as they are received, at progressive rates.

(2) The justification of this procedure has been the assumption that a summation of income items received during the preceding year, made as of the date of income-tax return, correctly indicates an ability of the several taxpayers to pay tax at progressive rates, such ability being in existence as of the date of the return.

(3) This assumption is based on a further assumption, namely, that a concept of "net income," which is derived from, and applicable to, a business unit can be transferred to an individual and used to measure his economic capacity.

All of these assumptions are contrary to fact. In the first place, the summation of personal income items over a calendar year does not reflect or measure or indicate an ability as of March 15 following. Because of the convenient vagueness of the ability concept, it has been endowed, in the popular thinking and discus-

[71] The immunity rule and the sixteenth amendment, passim.

sion, with a permanence which it does not possess. There is nothing in the least mysterious about the ability to pay taxes. It is of the same stuff, exactly, as the ability to buy ordinary goods and services. Anyone would admit that the time when a person can buy goods, or pay bills, is when he has the money in hand or at his disposal. No one would make the mistake of thinking that a person could pay his grocery bill, long after he had spent his money for other things. Yet, this appears to be assumed with respect to the tax bill. The ability to pay for things in the market comes with the receipt of income and goes with the spending of income. When the income is gone, the purchasing ability that it indicated is also "gone with the wind."

Likewise, there is an ability to pay tax that comes with the receipt of income and goes with its spending. It is as transient as the wind, and the procedure of summarizing all income receipts over a calendar year, as if the sum of these income items indicated a cumulative aggregate ability as of a date beyond the end of that year, means that the taxpayer is alleged to have ability at one time because he had—and spent—various items of income receipts during a past period of time.[74]

One obvious reply to this criticism is that the taxpayer should be aware of his future tax liability and should set aside a tax reserve from his income, as it is received. Such a policy can be followed, and doubtless is followed, by those who receive large incomes. But the writer's concern here is now with the few persons who have large incomes, those who can and do employ accountants, lawyers, and others to assist in the management of their estates and the income therefrom. While the argument applies, so far as concerns the question of ability, to the receipt of large as well as small items of income, the hardship of progression and its incongruity as a method of taxing according to ability, are far more apparent in the case of the great mass of income-taxpayers.[75]

With respect to all of these persons, the provision of a tax reserve is both difficult and unlikely. That the majority of persons do not take great forethought for any sort of future obligation, the social-security legislation bears witness. That it is futile to ask the workers, for example, to put aside a reserve for their share of the contributions under this act is also borne out by the collection of that share at the source. The method of income taxation employed in the Social Security Act, or that is exactly what it is, is definitely and vastly superior to the method employed under the income-tax laws. The tax is collected as the wages are paid, and it is therefore taken out of the worker's income at the one and only point of time when he can be said to have the ability to pay it. If this be true of the workers, it is equally true of a very large proportion of those who must now pay under the income tax. They are workers, for the most part, some of them paid rather better than those employees who must make social-security contributions, but all of them exactly the same kind of people with a scale of living more or less closely adjusted to income. For this entire group, which may be said to include all of the income taxpayers except a few thousands at the top of the scale, the imposition of an expost facto tax on a vanished income is a case of mistaken identity. A progressive tax system has been mistaken for a system of taxation according to ability to pay.

In the second place, the notion that in some mysterious way ability, although it actually comes and goes with the receipt and spending of income, carries over to the date of filing income-tax return, has gained its hold because of a misunderstanding and misuse of the concept of net income. As this term is used in income-tax laws, it means gross revenue or gross receipts less all of the costs and charges incurred in the process of acquiring the gross income. In this sense net income is a concept appropriate to a business and not to an individual. The business concern operates through the year, and if successful it emerges at the end with a net income. This net income is actually in hand, except for partial distributions during the year.

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[74] Cf. the writer's remarks on this subject in Proceedings of the National Tax Association, 1937, pp. 185-187; also, in the forth coming volume of the Proceedings for 1938.

[75] The recipient of a large income may invest a large portion of his cash receipts during the year in some business undertaking. That is, he may contribute to the supply of "risk" or "enterprise" capital. Should he do this, his ability to pay a large income tax, in cash, during the following year, has been as much reduced as if he had spent the money on any form of personal enjoyment or indulgence. The only defense of the present tax policy is that this person should have set up a tax reserve before making his investments. Had the tax been deducted from his dividends, interest, salary, or other receipts as they came in, the reserve would not be necessary.

The idea of a reserve is weak also in the case of large but variable incomes. No one can anticipate the reserve required, under a progressive tax scale, unless he can forecast his income for the entire year with reasonable accuracy.

In applying such a net income concept to the individual, it is evident that he is looked upon as being in some way almost wholly analagous to the business unit, and that he is regarded, therefore, as a human machine for producing income. This analogy is indicated by the deductions allowed individuals from gross income. They are the same as those allowed to the business unit, and they are all of a character appropriate to a business undertaking rather than to an individual as such. No other costs of income production such as would be peculiarly appropriate to a person as a person, rather than as an income-producing machine, are allowed to him. In lieu of all of these peculiarly personal costs of producing a personal income, the individual is allowed only certain small, arbitrarily determined amounts.

Since the ultimate purpose of individual effort in production is the satisfaction of wants through consumption, it is likely that a considerable proportion of all but the largest incomes must be consumed as received in order to enable the several recipients to continue to earn their respective incomes. There can be no positive generalization with respect to these peculiarly personal costs of income production, but some concrete illustrations of the sort of thing that is involved will make the point clear. Thus, a bad toothache or an illness may completely destroy one's efficiency for a time. Hence, one's dentist bill and doctor bill should be as legitimate charges against gross personal income as the maintenance charges for the upkeep of machinery in the factory. If a person breaks his leg, the costs of repair should be as legitimate a charge as would be the cost of repairing a broken machine in the factory. The individual cannot depreciate his training or skill, which are his working capital, but he can anticipate their decline by carrying insurance, the cost of which should be as legitimate a charge against gross personal income as the depreciation of wasting assets in a business.

Again, those who receive substantial incomes, such as professional men and business executives, are obliged to maintain a certain standard of living and of social relations in order to command that income. For such persons the small flat allowances on account of marital status and dependents bear no accurate relation whatever to the actual cost of producing an income of, say, $20,000 or even $50,000 a year. Those who receive such incomes from any kind of personal services simply cannot escape a substantial burden of cost which is really a cost of producing the income.

Consequently, much of what is summarized as personal net income for income-tax purposes is pure fiction, in a real sense of this term when applied to individuals. Because it is fictional, the use of progressive tax rates over a substantial part of the personal income range rests on a fictitious conception of ability to pay. A much closer approximation to personal tax ability would be attained by abandoning progression for all but the largest incomes and substituting a proportional tax, collected at source in the greatest degree possible. This method of tax collection imposes the tax at the only moment of time when any given item of income receipts reflects or indicates individual ability to pay the tax.

An exaggerated emphasis on progression and ability to pay, even with respect to the largest incomes, is likely to produce bad economic results, and any policy which produces bad economic results will in the end produce bad fiscal results. In enacting tax laws, legislatures have been persuaded, by those who have been capable of looking at only one part of the picture, to levy excessive taxes on large incomes on the ground that the ability to contribute to government is the sole obligation of these persons. Such an attitude completely neglects another obligation of those with large incomes, which is to supply a substantial part of the additions to the country's capital fund. This second obligation has been stressed particularly by Mr. Hanes, Under Secretary of the Treasury, and by Mr. Wenchel, chief counsel of the Bureau of Internal Revenue, in their testimony before the special Senate committee.[76] Both of these witnesses have deplored the lack of enterprise capital and the failure of those with large incomes to provide more of it. Neither of them has indicated any realization of the connection between the present tax policy and the ability to supply enterprise capital, assuming that the tax policy did not destroy the incentive to provide it. Extreme emphasis on the ability to support government has led to tax rates which disregard the ability and the obligation to support the economic system that must produce all income.

A government is justified in such a tax policy only if it proceeds, deliberately and successfully, to supply the enterprise capital which the tax policy has prevented individuals from supplying. No one can contend that, with the possible exception of Russia, there is any country now using severely progressive tax rates, which is filling the gap by providing enterprise capital on an adequate

[76] Infra, pp. 163, 167.

scale. Everywhere there is a suspicious correlation between excessive taxation of the savings fund, unemployment, and the public relief load.

The conclusion is that we have fussed and worried too much about tax progression. Under a different attitude and a more nearly rational tax policy, the magnitude of the alleged escape from taxation through the ownership of tax-free securities would diminish and a more realistic basis would be established on which to judge of the relative advantages and disadvantages of this policy. By comparison with the larger benefits of a sounder tax policy, however, the contribution of such a change to the solution of tax exemption would be only a minor accomplishment.

2. *The argument that the exemption or immunity of public securities from taxation diverts funds from private financing.*—Another argument that has been advanced in favor of the elimination of tax exemption and tax immunity is that the availability of such securities tends to divert from the field of private investment funds that would otherwise flow into that field. When Dr. C. O. Hardy investigated the subject more than a decade ago, he dismissed this contention as of minor importance.[77] Consideration of it at this time indicates that it is still of minor, or even of negligible, significance.

This argument has been advanced, however, from the early days of the discussion of the whole subject. Thus, Mr. Andrew Mellon, in a letter to the chairman of the Ways and Means Committee dated January 10, 1922, said:[78]

"This process (i. e., of issuing State and local securities) tends to divert investment funds from the development of productive enterprises, transportation, housing, and the like, into nonproductive or wasteful State and municipal expenditures, and forces both of the Federal Government and those engaged in business and industry to compete with wholly tax-exempt issues, and on that account to pay higher rates of interest."

The above passage contains certain allegations relative to the economic value of State and local expenditures which will be dealt with later.[79] Before proceeding with an examination of the argument that business and industry have been adversely affected, a more recent opinion will be presented. In an address by Mr. John Philip Wenchel, chief counsel of the Bureau of Internal Revenue, before the Investment Bankers' Association of America, at White Sulphur Springs, W. Va., on October 26, 1938, the following passage occurs:[80]

"It is extremely important that our economy have an adequate supply of 'risk' or 'enterprise' capital. There is at the present time no shortage of senior capital but there is an acute shortage of risk capital. The most promising source of risk capital is the savings of individuals in high income brackets, but the policy of extending tax exemption to public securities attracts much of this capital instead to a practically riskless field which might much better be filled by the savings of persons less able to afford to take a chance. If the tax exemption privilege were eliminated from future issues of public securities, we might expect, over the next generation, a gradual transfer to use as risk capital of a large proportion of the proceeds of such securities now held by individuals in the upper brackets. Thus it would appear that the effect of the existence of tax-exempt bonds upon the business life of the country is decidedly bad."

From these two quotations it appears that the emphasis of the fund diversion argument has shifted. Mr. Mellon thought that the whole supply of funds for private investment had been unduly diminished by the State and local borrowing while Mr. Wenchel now holds that it is only the supply of "risk capital" that has been depleted. He grants that the supply of "senior capital" is adequate.

The force of the diversion argument, whether it be set out in the terms used by Mr. Mellon or in those used by Mr. Wenchel, depends first, on certain matters of interpretation, and second, on certain matters of fact.

It is of course true that any particular sum which is available for investment at a given time cannot simultaneously be invested in public securities and in private securities. In this elementary, literal sense, any sale of a public debt issue, whether Federal or local, would absorb funds that could otherwise have been absorbed by industry. A qualification is necessary here in recognition of certain restrictions on the investments made by the Federal Reserve banks, the ordinary commercial banks, the public trust funds and the insurance companies. These agencies are not wholly free to supply what Mr. Wenchel calls "risk capital."

[77] C. O. Hardy, op. cit., ch. V.
[78] Quoted in a report of the Ways and Means Committee on Tax-Exempt Securities, January 11, 1924, 68th Cong., 1st sess., H. R. 30, p. 4.
[79] Infra, pp. 158-160.
[80] Quoted from a mimeographed copy of Mr. Wenchel's address.

Hence, when any governmental unit sells its bonds to a bank, a teachers' pension fund or an insurance company, it is not really diverting funds from industry, and certainly not from the risk or equity capital of industry. It is only in so far as individuals may select public bonds instead of industrial investments of any sort that there can be said to be an effective diversion of capital from private business.

But the validity of the diversion argument depends on what is expected to be the effect of the tax. If the tax is to restrict, effectively and materially, the amount of public borrowing, this can only happen through a substantial rise in the interest rate as the tax goes into effect. If the tax were to have no effect on the interest rate, as some Government officials have implied, there is no reason to suppose that such borrowing as has occurred, or as will occur in future, would have been, or will be, restricted.[81] And if there be no restriction, then the taxation of the interest on the public debt would be of no avail so far as concerns an increase of the funds available for industry.

The effect of that tax upon the volume of public borrowing would depend on the strength of the forces that have caused governments, Federal and local, to borrow. If the loans have been issued simply because relatively cheap money has tempted all governments into extravagance, then a rise of interest rates caused by the impact of the tax might exert some restraining influence. But if governments have borrowed in order to make more adequate provision of services that were demanded by the people or by the forces of social change, then the increased interest rates would not have checked the borrowing materially. That part of this question which affects the States and cities is dealt with in a later section.[82] Here it should be pointed out that any application of a diversion argument would involve the Federal borrowing in even greater degree than State and local borrowing, for the Federal debt is now considerably more than double the State and local debt.

The force of the diversion argument rests also upon certain matters of fact. During the twenties the Federal Government was reducing its debt, and the only net increase of public borrowing that occurred was that engaged in by the States and cities. What evidence is there that this borrowing produced an actual shortage of funds for private investment which was acute enough to be a source of embarrassment to industry?

According to the Census Bureau, the gross debt of the States and their subdivisions increased as follows from 1922 to 1932: [83]

Year and amount of gross debt

1922	$10, 255, 000, 000
1932	19, 576, 000, 000
Increase	9, 321, 000, 000

That is, State and local borrowing went on during this decade at an average rate of almost a billion dollars a year. But from 1922 to 1930 the Federal Government was releasing funds, through debt retirement, at almost as great a rate.[84]

Year	Federal interest-bearing debt	Gross Federal debt
1922	$22, 711, 000, 000	$22, 964, 000, 000
1930	15, 921, 000, 000	16, 185, 000, 000
Total decrease	6, 790, 000, 000	6, 779, 000, 000
Annual average	848, 700, 000	847, 400, 000

Therefore, a large part of the funds obtained by the States and cities from 1922 to 1930 may be said to have been simply an absorption of the public debt capital that was being currently released by the Federal debt retirement operations. The problem is, from the standpoint of the fund-diversion argument, to what degree did this absorption of funds by the States and cities hamper the growth of industrial capital through the same period?

[81] Cf. Tax Immunity and the Sixteenth Amendment, by the Department of Justice, especially p. 60.
[82] Infra, pp. 158, ff.
[83] United States Bureau of the Census. Wealth, Debt and Taxation, 1922, volume entitled "Public Debt," p. 80; Financial Statistics of States, Cities, Counties, and Other Local Subdivisions, 1932, pp. 52.
[84] Annual Report of the Secretary of the Treasury, 1937, pp. 410, 411.

A convenient measure of the growth of industrial capital is provided by the summary of balance sheet items published by the Bureau of Internal Revenue from the tabulation of income-tax returns. This tabulation began with the year 1926, and therefore does not supply information as to the effects upon industrial growth prior to that date. The following table gives some pertinent data for the years 1926 to 1935 inclusive: [85]

TABLE XVIII.—*Number of corporations, total assets, capital stock, and debt, from 1926 to 1935, inclusive*

[Dollars in millions]

Year	Number of corporations submitting balance sheets	Total assets	Capital stock (common and preferred)	Bonded debt and mortgages
1926	359,449	$262,170	$84,663	$30,801
1927	379,156	287,642	91,581	37,740
1928	384,548	307,218	95,731	42,943
1929	398,815	335,778	105,258	46,643
1930	403,173	334,002	106,184	50,282
1931	381,038	290,497	99,011	49,101
1932	392,021	280,093	97,489	47,222
1933	388,564	283,206	92,482	45,883
1934	410,626	301,307	104,940	48,604
1935	415,205	303,180	102,266	49,822

It will be noted that in the 5 years 1926-30, inclusive, there was a steady growth in the number of corporations, and in the total of their assets. The increase of assets in the 5-year period was $72,823,000,000. This occurred in a time when the Federal Government was paying off debt, and the total State and local borrowing was not more than some six or seven billions, at most. That is, industrial assets increased by tenfold the total amount of the State and local borrowing. The secured debt borrowing of private industry from 1926 to 1930 increased by almost 20 billions, or by something like threefold the debt increase of States and cities in the same time. It would be extremely difficult to find in this record of the growth of private business any evidence that the amount of borrowing by the States and cities had exerted an appreciable retarding influence.

The second 5-year period covered by the above table reflects the influence of the depression, and to some extent also the influence of the change of Federal tax policy, as indicated not only by the increase of tax rates but also by other changes to be mentioned presently. The number of corporations has increased, until it stands above the number reporting in 1930. But the recovery of assets has not kept pace with the increase of numbers, and the amount of capital financing, for both the senior and the junior forms of capital ownership, has increased but little.

It is difficult to find a trace of the influence of State and local borrowing upon the course of business growth in either the second or the first 5-year period. The gross interest-bearing debt of the States and their subdivisions increased from $19,103,000,000 in 1932 to $19,152,000,000 in 1937.[86] For the time being the States and cities have stopped borrowing except for refunding purposes. If there has been a diversion of capital funds from industry, since 1932, it is necessary to look elsewhere for the cause than at the State and local borrowing program, for there has been no such program.

A more exact indication of the flow of investment from all sources into capital formation is given in the following figures, prepared by Simon Kuznets.[87]

[85] Statistics of Income, 1935, pt. II, p. 25.

[86] Treasury Gray Book, p. 51. As of 1932, this authority estimates the State and local non-interest-bearing debt at $474,000,000 in 1932, which reconciles the State and local debt figure just given with that quoted from the Census Bureau on the preceding page. The Census reports do not give the non-interest-bearing debt.

[87] Simon Kuznets, National Income and Capital Formation, 1919-35. Published by the National Bureau of Economic Research, 1937. The data given in the table are from pp. 45 and 48.

TABLE XIX.—*Gross and net capital formation, 1920–34, inclusive*

Year	Gross capital formation (3-year moving average)	Net capital formation (including net changes in business inventories)	Year	Gross capital formation (3-year moving average)	Net capital formation (including net changes in business inventories)
1920	$17,643,000,000	$11,650,000,000	1928	$18,777,000,000	$8,168,000,000
1921	15,623,000,000	3,693,000,000	1929	17,261,000,000	10,092,000,000
1922	14,323,000,000	5,802,000,000	1930	14,141,000,000	3,879,000,000
1923	15,575,000,000	6,691,000,000	1931	8,424,000,000	278,000,000
1924	17,552,000,000	6,823,000,000	1932	5,203,000,000	4,427,000,000
1925	17,831,000,000	10,644,000,000	1933	4,492,000,000	2,987,000,000
1926	18,819,000,000	9,734,000,000	1934	6,416,000,000	1,855,000,000
1927	18,356,000,000	8,859,000,000			

Gross capital formation is the total original investment of national income in the various forms of capital goods, and net capital formation is the net increase of capital after deduction for depreciation, depletion, and actual disappearance in use.

The fact of the matter appears to be that in prosperous times, with a reasonable tax system, there is an abundance of capital funds, and the productive capacity of the national economy can well support both the expansion of private industry and the necessary growth of public services. In adverse times the diminished productive capacity of the national economy cannot properly support both industry and government on the same scale as is possible under happier economic circumstances. This incapacity is intensified by excessive taxation of the sources of the capital fund.

The general effect of taxation.—Since this report deals with certain aspects of taxation policy, and also since the subject has already been raised by the Chief Counsel of the Bureau of Internal Revenue, Mr. Wenchel, in the passage quoted earlier, it seems appropriate to make some suggestions on the topic of the supply of risk or enterprise capital, with particular regard to the relation of the taxation policy in general to this supply.

Taxation is unquestionably an important factor in shaping the general attitude of investors. But in this respect far more weight attaches to the character of the taxation policy as a whole than to the relatively narrow and limited field of the public securities, and especially to the still more restricted field of State and local securities. Here, it is respectfully submitted, is the cardinal error of Mr. Wenchel's argument. The subject of the address from which a quotation was given above was "The Elimination of Intergovernmental Immunities." The argument advanced in that paper was that intergovernmental immunities should be ended, particularly with reference to the power of the Federal Government to tax the interest on State and local securities, since their existence prevented those with large incomes from investing in so-called "risk capital."

The data that have just been given indicate that the existence of intergovernmental immunity did not prevent a steady and rapid growth of investment in industry during the twenties. The fact that virtually no net increase of State and local borrowing has occurred since 1932 is further evidence that there has been no draining off of investment funds in this direction of late years which can be attributed to the tax immunity of State and local bonds. The question of the possible connection between the huge increase of the Federal debt since 1930 and the scarcity of risk capital is not here considered, since it does not involve in any way the subject of intergovernmental immunity.

There is a correlation, the significance of which should not be overlooked, between the volume of production, the growth of industrial capital, the level of employment, and the main features of the Federal tax policy. Reduction of the surtax rates from the high level of the war period began in 1924. Reasonable, though not liberal, provision was made for the forward deduction of net losses, and there was no provision for the taxation of undistributed earnings except as it could be shown that earnings were being accumulated in excess of the reasonable needs of the business.[88] It is hardly necessary to look further than

[88] By the Revenue Act of 1924 the maximum surtax rate was reduced from 55 to 40 percent, and by the act of 1926 this maximum was set at 20 percent. In 1932 it was raised to 55 percent, and in 1935 to 75 percent. Net loss deduction was permitted into the third year following, but this was reduced to the ensuing year by the act of 1932 and entirely eliminated in 1933. Taxation of undistributed profits was introduced in 1936.

at the present taxation policy, by comparison with that of a decade ago, to find an adequate reason for the reluctance of investors to assume even the normal risks of enterprise, not to mention the abnormal risks of new or hazardous undertakings.

Mr. John W. Hanes, Under Secretary of the Treasury, accurately described the investor reaction toward the risks of enterprise in his statement before the special Senate committee. Mr. Hanes said:

"It is highly important that capital should have an adequate incentive to enter venturesome enterprises. We are confronted today with a great surplus of capital which does not desire to take a chance, and a distinct shortage of that which does. Venturesome capital is needed to induce the investment of cautious capital. New enterprises can be started and old ones that are subject to rapid technological and stylistic change can be continued only with capital willing to take a chance. Moreover, even our most stable industries need a margin of enterprising capital willing to absorb the shock of the risks to which even these industries are subject, in order to permit them to secure senior capital through the issuance of bonds and preferred stock. The employment of a dollar of venturesome capital may permit the employment of several dollars of senior capital, but if no one is willing to take a chance, projects may be abandoned even if the earnings prospects are promising.

* * * * * * *

"Two conditions are required to cause men to take a chance: First, a reasonable probability of gain, and second, the necessity for taking the chance to make the gain. No man will call 'tails' on the toss of a coin if he knows it has heads on both sides, but neither will he bet at all on a fair coin if he has a chance to call 'heads' on the double-headed one."

Mr. Hanes' purpose was, of course, to clinch the case against the exemption of public securities. But what he said served rather to clinch the case against the Federal tax policy in general, for that policy could hardly be better designed to destroy the two conditions which, as Mr. Hanes says, are required to cause men to take a chance. This tax policy has "heads" on both sides, and the taxpayer is never permitted to call the turn.

That this is not simply a personal and prejudiced view of the writer's is shown by the following passage from Facing the Tax Problem, a recent publication that has attracted wide attention.[89] This passage deals with the effect of the tax system on business enterprise:

"People must be induced to risk money if the private capitalist system is to function. Of course, the investor is not the only one who assumes a risk. In practice, however, more options are open to him than to others, and the effect of tax policies on his decisions is generally both the most powerful and the most direct.

"His willingness to risk money is only one part of business initiative. Another is the willingness to exert effort in promoting and managing businesses. This factor, however, seems even more uncertain and will not be covered in the present analysis.

"The taxes that are most commonly accused of weakening the willingness to risk are income taxes, death taxes, and gift taxes, when they are levied at progressive rates—that is, rates that increase as the amount to be taxed increases.

"To some extent, investors weigh the chances of success and failure before placing their money. By imposing an income tax on profits, the Government claims a share in the gains without offering to share in the losses. The result is something like an unfavorable shift in gambling odds, and it may be enough to deter the investor. Whether it will or not depends on the other courses of action open to him, and how they appeal to him.

"He may turn to some other field of business that offers less reward and also less risk. Since a tax at progressive rates, such as the Federal income tax, takes a smaller proportion of the income as the income shrinks, the Government will claim a smaller proportion of the less spectacular reward.

"Suppose, for example, that an investor estimates roughly that he has 1 chance in 10 of succeeding in venture A, where success will bring $500,000, and 1 chance in 2 of succeeding in venture B, where success will bring only $50,000. Suppose, further, that the 2 ventures are about equally attractive to him until he considers the income tax. A steeply progressive income tax that will cut down the net reward of venture A by a much larger percentage than it will the reward of venture B will induce him to choose venture B.

[89] Facing the Tax Problem, pp. 61-63. Published by the Twentieth Century Fund (New York), 1936.

"If personal exemption, earned income credit, etc., are disregarded and if the venture chosen is the investor's only source of income for the given year and is conducted as an unincorporated business, the present Federal tax will cut the return from the risky venture from $500,000 to $194,000. Similarly the gain from the relatively safe venture, B, will be cut from $50,000 to $40,300. A comparison of $194,000 with $40,300 is of course quite different from a comparison of $500,000 with $50,000.

"Although nothing is known of the actual extent of such influences, it seems reasonable to assume that the present Federal income tax is exerting an effective pressure on many investors to turn away from high-risk ventures to relatively safe fields of business.

"The pressure depends on both the high rates and the progressive feature. The investor may be so rich that he is already in the top parts of the income tax schedule, where the progression is slight. If the choice between venture A and venture B as described above is to be made by an investor who already has a net income of $1,000,000, the problem changes. Since that part of his income over $1,000,000 but less than $2,000,000 is taxed at 77 percent, in effect the $50,000 from venture B and the $500,000 from venture A will be taxed at the same flat rate. The rate is so high that the investor may decide to select neither venture, but at least the degree of weighting against the risky enterprise that was noted in the first example no longer exists.

"The investor may, of course, purchase State or municipal bonds, or short-term Federal securities and thus avoid entirely both the Federal surtax and the Federal normal tax. His investment in such securities does not necessarily deprive business of capital funds, as has been often charged. For every buyer there is a seller, and the person who sells the bonds now has the same investment problem that the buyer used to have. The only way in which the tax-exempt feature can hamper business initiative by depriving it of capital is by increasing the total amount of tax-free securities outstanding.

"In other words, for State and local issues, the proper question is: How much fewer securities would the States and localities sell if the interest on their bonds were not exempt from Federal income tax? This is another way of asking whether these bodies, when deciding whether to incur a debt, attach much importance to the rate of interest that they have to pay. The answer is largely a matter of opinion. The writer's present impression is that the volume of State and local debt has not been much influenced by exemption from the Federal tax.

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"An economic limit may be reached through a discouragement of saving rather than of willingness to risk. The two are closely related, as has been seen. If the possible winnings in a risky enterprise are cut down by taxation while the chances for loss remain as before, capital may not enter that field. Perhaps the capital that would have gone into the risky field under a different tax system will not be accumulated at all. Thus a progressive income tax, if high enough, may tend to restrict capital accumulation."

The viewpoint that the present tax policy is disadvantageous, not only for industry but for the revenue, was recently expressed by Senator Harrison, of Mississippi. The following quotations are from a report of his address at Detroit on December 19, as published by the New York Times of that date:

"Discussing the tax question, the Senator said that it had been necessary for the Government to tap every source of revenue, with the result that Federal taxes were heavier today than in any other peacetime period.

" 'In the imposition of surtaxes in the higher brackets we have reached the point of diminishing returns,' he asserted.

" 'The country,' he declared, is 'suffering from high blood pressure.

" 'I shall not undertake on this occasion to discuss the causes for this condition. No common agreement can be reached by the diagnosticians, but we must agree that if the exercise has been too violent, some modification must be employed and proper diet and rest be prescribed.' "

3. *The argument that tax immunity has encouraged State and local extravagance.*—Another minor argument is that tax immunity for State and local bonds has stimulated their issue and thus has led to a greater use of public credit in State and municipal financing than the local needs have justified. The relatively low interest rates at which this paper could be sold, it is said, have tempted them to issue more of it than they would have issued if the interest cost had been higher. Hence, it is concluded that the Federal tax would be a good thing in that it would be a wholesome restraining influence upon State and local borrowing.

If this argument be stressed it involves admission that the effect of the Federal tax would be to increase the interest cost of the State and local debt. Otherwise the imposition of the tax would have no restraining effect.

Judgment as to the wisdom and necessity of State and local borrowing is not easy. Instances may be found, particularly in the municipal field, which indicate laxity in the use of public credit by municipal officers, who were able, by borrowing at long term for the purchase of short-lived equipment and for the payment of current operating expenses, to keep the tax rate down for the time being.[90] Going further back, it is possible to find periods in the history of State financing in which abuses were committed in the issue of State bonds.[91] But if the use of public credit for the financing of current expenses be an infallible indicator of waste and extravagance, then the history of the Federal finances in recent years will provide ample basis for some strong sermons on the wasteful issue of public bonds.

The fact is that much of such improper use of public credit as there may have been by States and cities occurred a long time ago. The bulk of the State and local debt now outstanding has been created since the beginning of the present century, and a large proportion of it has appeared within the past 25 years.[92] During this period there has been increasing regard for proper standards, and increasingly strict control by legislation and by administrative agencies over the purposes and the amounts of the debt that could be issued. With respect to the existing indebtedness, therefore, it is by no means possible to say, as might have been said of some of the nineteenth century State and municipal loans, that they were produced by lax or corrupt political administrations, or that they represented foolish or wasteful expenditures.

The statement by Mr. Mellon which was quoted above[93] would be more accurate as a judgment of the character of the State and local debt financing before 1900 than of that which now exists. There was relatively heavy State and local borrowing during the twenties, but the Federal financial needs of the war period had led to a severe curtailment of all financing, both private and public, except that which had a clear relation to the war effort. The best test of the need and of the usefulness of the present outstanding State and local debt is provided by a survey of the purposes for which the loans have been made.

(*a*) *The purposes of State and local borrowing.*—The purposes which have been served by State and local borrowing over the past 20 years or so, are revealed by the Census Bureau reports, in which the principal purposes of this borrowing are shown, insofar as the records have permitted the Bureau to make a classification. The historical trend, in the case of the States, is illustrated by the data in table XX.

The last report of the Bureau on the financial statistics of States is for the year 1931. The lack of more recent data is somewhat unfortunate, for the Treasury Gray Book presents figures which show that between 1932 and 1937 the total interest-bearing debt of the States increased by $402,500,000.[94] No information is available to show the purpose for which this more recent borrowing was done, but some part of it, at least, was for various emergency purposes during the depression years. What part of this latest increase of the aggregate State debts may have been wasteful or unnecessary it is impossible to say, but there is no external evidence to show that it represented an improper use of public credit inspired by the tax exemption privileges which the bonds commanded.

Turning to table XX, it is seen that all of the State debt, the purpose of which can be positively identified, has been incurred in the provision of equipment—lands, buildings, roads, bridges, and other facilities—to be used as part of or in connection with the public services which the States are performing for the people. The accelerating tempo of change during the past quarter century has forced upon the States and their subdivisions an obligation to provide services and facilities at a rapidly expanding rate. It is by no means certain that the country has come to the end of this acceleration, and that the demands of the future will be any less extensive or less urgent, than have been those of the past generation. It would have been very difficult to do all of the things called for, in the volume in which they were demanded, out of current tax resources. No doubt this difficulty will be experienced in the future. At any rate, in the past it was the current popular judgment that public credit should be used, and the result was that the bonds were issued. In rejecting the charge of extravagence, there is no intention to defend each and every issue as being a prudent and economical application of the States' resources. But by and large there has been no greater waste here than at any other point in the governmental system.

[90] Cf. H. C. Adams, Public Debts (1887), pt. III.

[91] Cf. W. A. Scott, The Repudiation of State Debts (1893).

[92] In 1913 the gross debt of the States and their subdivisions, less sinking fund assets, totalled $3,821,897,000. Bureau of the Census, Wealth, Debt, and Taxation, 1913, vol. I, p. 229.

[93] Supra, p. 153.

[94] Op. cit., p. 52. The increase of State debt was accompanied by a reduction of local debt sufficient to produce only the small over-all increase shown on p. 154 above.

TABLE XX.—*Funded, floating and special assessment debt of the States at close of year classified by purpose*

Purpose	1916	1919	1924	1928	1931
General governmental purposes:					
Government buildings, including armories	$21,875,000	$18,368,000	$17,948,000	$44,967,000	$46,663,000
Highways	234,711,000	304,959,000	704,407,000	1,088,636,000	1,425,616,000
Agricultural improvement	170,000	248,000	2,614,000	25,184,000	4,123,000
Charities, hospitals, and corrections	17,361,000	16,891,000	24,041,000	33,632,000	82,757,000
Education	9,626,000	9,396,000	29,887,000	41,268,000	56,328,000
Parks and reservations	7,023,000	11,949,000	16,321,000	31,586,000	28,414,000
Soldiers and sailors' relief and homes	374,000	224,000	248,127,000	254,684,000	225,498,000
Miscellaneous and unreported	172,376,000	185,501,000	198,070,000	255,979,000	363,179,000
War loans	1,241,000	9,980,000	7,483,000	5,762,000	6,647,000
Subtotal, general governmental purposes	473,757,000	557,516,000	1,283,904,000	1,770,602,000	2,239,427,000
Public service enterprises	22,638,000	45,040,000	140,319,000	290,506,000	294,870,000
Funding and refunding	54,674,000	63,803,000	70,187,000	[1] 59,733,000	[1] 63,200,000
Grand total	551,019,000	666,359,000	1,494,410,000	2,061,107,000	2,534,297,000

[1] The Census Bureau excluded funding and refunding bonds from the grand total. In other years, such bonds are excluded from amount reported if they represented a funding or refunding of earlier issues the purpose of which was known, being, in such case, classified under the appropriate purpose.

Considering the purposes for which the States have borrowed, it seems reasonable to question whether the movement which forced the construction of roads, school and other public buildings, parks, hospitals and the like, would have been materially restrained by such increase of interest costs as Federal taxation would have produced. Nor does it seem likely that such would be the result in future. There has been an apparent, if not a real, element of necessity in this borrowing. The probable result would have been in the past, as it will be in future if the interest from such bonds is made taxable, a payment of the higher cost involved as part of the necessary price of the improvements.

The purposes for which the units of local government have borrowed have been much the same as those which have motivated the States. The picture at this point must be left incomplete, for no agency has compiled uniform records of all local borrowing according to the purposes of the loans. The Census Bureau's data for the larger cities are summarized in table XXI.

This record of the purposes for which the cities have borrowed is much the same as for the States, and no further comment is required on the significance of those purposes, or on the effects of a Federal tax on the future cost of similar loans.

Apropos of the charge of State and local misuse of borrowed funds, the following statement by Mr. John N. Garner, in the debate on the proposed tax-exemption amendment in 1922, is enlightening: [98]

"Who are the people back of the propaganda for this amendment? I have tried to show you that the President said the real reason for it was that it would restrict the issuance of these State and municipal bonds, so that the money could go elsewhere into other kinds of business. I thought to myself, when I heard him read that portion of his message, what is more important to this country than the building of schoolhouses, the construction of good roads, the reclaiming of the desert lands, and the cultivation of the waste places. These things are conservers of civilization. If they fail, our boasted civilization sinks into chaos."

[98] Congressional Record, vol. 64, pt. I, p. 712, 67th Cong., 4th sess., December 19, 1922.

TABLE XXI.—*Funded and special assessment debt of cities at close of year*

[In thousands of dollars]

Purpose	Cities of 30,000 population and over—					Cities of 100,000 population and over, 1936
	1915	1919	1924	1928	1931	
General governmental purposes:						
General Government buildings	89,935	109,192	71,422	98,457	189,305	146,542
Police and fire	41,650	46,951	55,838	74,072	99,047	75,522
Sewers, etc.	205,577	245,777	403,461	671,138	806,161	674,554
Highways	448,799	506,468	667,275	1,049,481	1,438,627	910,883
Charities, hospitals, corrections	50,880	55,086	69,278	94,420	181,863	297,074
Education	373,225	476,998	798,703	1,149,024	1,734,303	1,242,335
Parks and playgrounds	159,783	176,821	162,113	266,701	350,696	301,144
Miscellaneous and unreported	569,753	649,214	426,147	641,591	1,125,306	1,193,308
Subtotal, general governmental	1,939,602	2,328,508	2,654,231	4,045,793	5,945,378	4,841,363
Public-service enterprises	960,001	1,191,476	1,004,719	1,389,591	2,977,934	2,823,835
Funding and refunding	164,729	176,035	143,058	171,662	219,895	[1] 584,961
Total	3,064,332	3,696,020	[2]5,779,025	[2]8,022,532	8,923,306	7,665,198

[1] Not included in the total.
[2] New York City debt is included in the total, but not distributed according to purposes. The totals were: 1924, $1,977,016,000; 1928, $2,587,148,000.

(b) *The refunding of State and local debt.*—If the tax immunity of State and local debt be eliminated, the transition to taxable status will be speeded up by the process of refunding, and the incidence of the new burden will fall unevenly, since not all of the States and cities will be obliged to deal with a refunding situation at the same time. There is an increasing use, among the cities and other local subdivisions, of serial redemption, a method of debt retirement which does not contemplate refunding. But the cities have not all been able, during the past 8 years or so, to maintain the regular schedule of serial redemption, nor have all of them as yet established their entire debt on a serial basis. Consequently, there must be a considerable amount of refunding over the next decade.

Every refunding issue offered after the tax immunity is removed will be subject to such increase of interest costs as may be produced by the Federal tax. Therefore, those States and cities which must look forward to an early refunding of a portion of their presently outstanding debt will be obliged to assume the increased interest burden earlier than those units which may be so fortunate as to have refunded already, or which need not face the necessity of it.

Two conspicuous instances have come recently to public attention in this respect. One is Philadelphia, where the mayor proposed, in December 1938, a general refunding of the city debt in order to save on interest costs.[96] In 1936 Philadelphia's debt amounted to $636,329,000 on which the interest paid during the year was $26,319,000, or an average rate of 4.13 percent.[97] Unless this refunding can be carried through prior to the removal of tax immunity, the amount of saving for the city will be very small.

The other case is Detroit, a city which also faces a refunding problem. This problem has been outlined by Mr. Henry Hart, vice president of the First of Michigan Corporation, as follows:

"It happens that the city of Detroit has outstanding approximately $118,000,000 of bonds bearing 4 percent or higher interest rates, which are callable at par on any interest date. Of this amount, $74,000,000 bear 4½ percent or higher interest rates. This is the result of the default and general refunding of Detroit bonds in 1933–34. The city had $80,000,000 additional of callable bonds which it called for payment in recent years out of the proceeds of refunding bonds sold at substantially lower interest than the bonds refunded. As a result of the refunding of those $80,000,000 the city is saving each year $1,142,000 interest cost. It is anxious to continue this refunding program as soon as market conditions will permit, and it is readily conceivable that the city might save in interest charges an additional $1,000,000 a year on such refunding."

[96] Reported in The New York Times of December 13, 1938.
[97] Cf. Financial Statistics of Cities, 1936.

Mr. Hart points out also that the entire State debt of Michigan matures in 1944, and that some of this debt must be refunded, because certain bonds held in the sinking fund will not have matured by that time and these bonds will not be salable for cash except at a very substantial discount.

The recipient of this report, the comptroller of New York State, has recently discussed the effect of the removal of tax immunity on the cost of debt financing in his own State. Addressing the fiscal officers, the comptroller said, in part:

"Existing tax exemption makes a price difference of about three-fourths of 1 percent on bond interest per annum. Therefore, on the basis of a 3-percent coupon, this obviously means a 25-percent increase in interest charges—with nothing in the way of jobs or services to show for it.

"Bonds totaling approximately $500,000,000—still unissued—have been authorized by vote of the people of this State. Assuming an average life of 20 years for these bonds, an additional three-fourths of 1 percent in interest charges could obviously add as much as $75,000,000 to the ultimate cost of completing this financing.

"But that is not the only serious aspect. Under the proposed statute the States 'theoretically' would be given reciprocal powers to tax Federal securities. While such 'reciprocity,' even as concerns the States, is largely one-sided, the very theory of reciprocity would not extend to municipalities. To them the increased interest costs would mean a dead loss. Are they prepared to assume this burden?

"It is estimated that by doing away with the tax exemption on State and municipal bonds the Federal Government's revenue will ultimately be increased thereby by approximately $300,000,000 annually. Even assuming the correctness of this estimate, nobody ever collects money without somebody else paying its equivalent. Who pays it in this instance? The ordinary local taxpayer upon whose property the tax differential would have to be assessed by the issuing municipality.

"Some authorities argue that taxing public bonds would force capital to venture more into private enterprise. But it is difficult to conceive how the mere addition of a tax handicap to the one type of security would of itself reduce the risks inherent in the other. Certainly such a tax could not alter the relative merits of existing credits.

"Speaking generally, no proposal in modern times has been so fraught with danger to the American fiscal system or to the fundamental American principle of decentralized powers. Certainly no legislator, either State or Federal, who can truly claim to represent the constituents who elected him, can possibly favor a statute of such serious consequences."

(c) *The purposes of future State and local borrowing.*—In the light of recent developments it is possible to foresee that some of the larger problems which must be dealt with by the States and cities will relate to activities and services that will involve substantial aid to different low-income groups, or to different sections with small local capacity to provide for their own needs. For example, in every large city there is a problem of slum clearance, and in some sections there are so-called rural slums that call for removal or rehabilitation. The rapidly mounting hazards of motor traffic demand large expenditures, especially in the congested areas, for wider traffic lanes, divided highways, and grade crossing elimination. The need for good, low-cost housing has already been recognized by the enactment of Federal legislation.

In these and other similar activities the States and cities must participate, and they will be expected to provide part, at least, of the funds. The proposed removal of tax immunity therefore bears directly upon the terms on which they shall do their share of such financing as may be required. It is clear, from the evidence submitted in part I of this report, that the subjection of State and local bond interest to Federal taxation will increase the cost of the funds for these important welfare activities. This increase will fall, either upon the general local taxpayers or upon those for whose benefit the projects are to be executed.

(d) *The revenue bond.*—Reference was made above[88] to the situation of the various authorities which may issue bonds but which have no power to levy taxes. The bonds of such agencies are secured only by the revenues which are earned. The cities have likewise developed the "revenue bond," especially in connection with self-liquidating projects. The principal reasons for the use of a revenue bond have been (1) the need of escaping stringent tax or debt limitations applicable to general obligations, and (2) the influence of Federal aid in the expenditure of public funds for the construction of self-liquidating undertakings.

[88] Supra, p. 135.

Whether the revenue bond be issued directly by a municipality or by some authority established to construct and operate a service facility such as a bridge, tunnel, or parkway, they have heretofore been accorded a status of tax immunity. Since they are not supported by the taxing power, their market status, even with tax immunity, would be definitely below that of the general obligation bond. If the investor must face the certainty of Federal income taxation with respect to these bonds, as well as the uncertainty of any income which inheres in the fluctuations of the business done by the service in question, it is possible that the future market for this type of bond will be materially restricted if their tax immunity is removed. Consequently the further construction of the projects that would otherwise be financed through the flotation of the revenue bond would be effectively checked.

(c) *Tax immunity and low-rent housing.*—The construction of low-rent housing, on an extensive scale and at a level of costs that will assure adequately low rents, is typical of the newer social needs. The interest in this subject, and the pressure that is being exerted to set in motion cheap housing construction over a wide front, are too familiar to be rehearsed here. The significant aspect of it, from the viewpoint of this report, is the bearing that the removal of tax immunity may have upon the achievement of the desired goal, which is to stimulate a considerable volume of construction, at costs low enough to enable those in the lower income groups to have proper housing.

One important factor in low cost housing construction is the cost of the capital funds. If this undertaking is to be put on a self-sustaining basis, it will require a level of rentals which will be sufficient to pay the interest and also the amortization charges on the investment within the reasonable useful life of the improvements constructed.

An examination of the United States Housing Act of 1937 [99] reveals that it is filled with provisions and conditional requirements, for tax exemption. The National Housing Authority shall be completely tax exempt. It is authorized to issue notes or bonds having a maturity of not more than 60 years, to be exempt from Federal normal tax and from all taxes imposed by the States or their subdivisions. The public housing agencies may issue bonds that are to be exempt from all Federal taxation. The Authority may contract to make annual contributions to public housing agencies in order to assist in maintaining the low-rent character of their projects, but no such contribution shall be available until the State or its subdivision has contributed, "in the form of cash or tax remissions, general or special, or tax exemptions, at least 20 percent of the annual contribution herein provided." A similar condition is attached to capital grants to any public housing agency, except that the local share may be provided by a contribution of land or of other facilities in lieu of tax remission or exemption. It must be apparent that whatever the form in which the local contribution or tax exemption is granted, it can only be done at the expense of other taxpayers in the community.

It was expected that the public housing agencies (defined in the act as any state, county, municipality or other governmental entity or public body which is authorized to engage in the development or administration of low-rent housing or slum clearance) would obtain the funds for their projects from the Authority. Nothing in the act would prevent any public housing agency from issuing its own bonds and this has been done in one case, at least.

The plan for utilizing private funds in the construction of low-rent housing which has been inaugurated at Princeton, N. J., deserves mention here as an example of the kind of enterprise which has for so long been vainly hoped for in the housing field. It rests squarely on the assumption that the bonds issued under it will continue to be tax exempt. In brief, the plan is as follows: The author of the idea, Mr. Gerard Lambert, contracted with the borough of Princeton to build certain low-rent housing units. He accepted in payment bonds issued by the public housing agency established by the borough under the national act. These bonds are not general municipal obligations, but are secured only by a lien against the properties constructed. The amortization period is 28 years, after which the houses become the unencumbered property of the borough. Without the prospect of tax exemption for the interest on the bonds, the rents would need to be increased or the amortization period extended. The one alternative would tend to defeat the main purpose of the project, if it did not entirely prohibit private financing of this sort. The other would leave a shorter span of useful life for the improvements after amortization and would curtail the advantage of such properties as a future source of public revenue for the municipality.

[99] Cf. United States Code Annotated, title 42, 1936, sec. 1401, ff.

In whatever manner the funds are secured, however, the numerous references to tax exemption in the National Housing Act indicate the extent to which Congress was impressed, in enacting this law, with the importance of taxation as a factor in the cost of housing. The housing agencies may obtain funds from the Authority at "not less than the going Federal rate of interest plus one-half percent." The going Federal rate is defined as the annual rate of interest specified in the then most recently issued bonds of the Federal Government having a maturity of 10 years or more.

It therefore becomes a matter of some interest as to what will be the effect on the costs of these projects of the general elimination of tax exemption. That it will cause some increase in going Federal rates of interest seems certain unless there is deliberate governmental interference to prevent this result.[1] But an exemption policy of this sort cannot be maintained without scattering its benefits in various directions. The tenants of the low-rent projects will benefit if the rents can be kept down. It is true, also, that those who buy the housing bonds will likewise derive some benefit. This is one example, but only one, in which the issue of tax exemption or tax immunity leads to a balancing of the benefits in different directions. The tax exempt farm loan bonds is another example. If it were possible to secure all of the benefits of a lower rate of interest in one direction without having to confer certain benefits in another direction, the ideals of those who are particularly, even solely, concerned with the operation of the progressive income tax could doubtless be satisfied.

This one-sided adjustment does not seem likely, except through some kind of governmental strong-arm manipulation of the money market, a course which is so threatened by serious consequences of other sorts that it cannot be justified, although it has been done.

The housing problem and the farm-relief problem serve very well to set forth the tax exemption issue in its essentials. In each instance there is a case, or there appears to be a case, for using the public credit in the accomplishment of certain objectives, and in furtherance of these purposes it has been deemed worth while to exempt from taxation the interest paid on the bonds. The motive was to reduce to the lowest terms the cost of providing the funds for the respective purposes. The exemption has been granted in the full knowledge of the fact that it would interfere, pro tanto, with the rigorous application of progressive taxation. Such a result is as inevitable as it is obvious.

So far as concerns the purposes of government there is no difference between the benevolence of the Federal Government in helping the farmers or those who need low-rent housing, and the benevolence of State and local governments in building roads, providing schools, libraries, and hospitals, and performing the other services which devolve upon them. In either case it is a question whether the harm done by a somewhat imperfect application of a none too well justified scheme of taxation is more significant than the benefit conferred upon the remainder of the citizens.

TAX IMMUNITY AND THE FEDERAL SYSTEM

Viewed in the large, the broad issue of which the conflict over an extension of the Federal taxing power is a conspicuous illustration is a contest between those who desire greater Federal centralization at any cost and regardless of consequences, on one hand, and on the other hand those who seek to preserve the balance of powers which is not only implied in, but which is essential to, the maintenance and continuance of the Federal system. The advocates of continued and extreme Federal centralization may not realize that to impose no restraints whatever upon their efforts means the destruction of that system. It may be that a majority of the people are ready to see that system supplanted by some other, selected from the considerable variety of undemocratic types now on exhibition in various parts of the world. It is at least important to understand just what fundamental issue is involved here.

The centralizing movement has been under way for a long time. In consequence, the country has already gone a long way toward an overemphasis of the Federal powers and jurisdiction. In 1923 a competent survey of the then existing situation was published, in which the following passage may be found.[2]

"Government in the United States has been, and so long as our constitutional system is retained, will probably continue to be an experiment in federalism. In fact, every federal state is an experiment. Federalism, by its very nature, necessitates constant adjustment of governmental functions between the central govern-

[1] The New York Times of November 14, 1938 quoted Mr. Aaron Rabinowitz, vice chairman of the New York State Board of Housing, to the effect that Federal taxation of the interest paid on housing bonds would mean an increase in rentals of at least $1 a month per room.

[2] W. Thompson, Federal Centralization (1923), pp. 3, 4.

ment on the one hand and the integral federated units on the other. It is always difficult, perhaps impossible, to draw a fixed line delineating the respective functions of the central agency and the local units. Hence the experimentation and the tendencies to adjust and to readjust governmental functions in federal systems of governments.

"The problem of division of powers in federal states is not merely a philosophical question to engage the attention of academic students of government. Neither is it mainly a question of constitutional law or statutory construction. It is a practical rather than a philosophical question. The very life of a federal system depends upon a workable adjustment of the powers and functions of the central agency and the component local units. *If the states are exercising powers in such a manner as to impede the proper functioning of the general government, the federal system is in danger of disintegration. If the central government, on the other hand, interferes with the free exercise of those powers which inherently and constitutionally belong to the states, there is a danger of the states being absorbed into a strongly centralized system which is federal in name only.*" [Italics ours.]

The keynote of the above passage is the proposition that the successful operation of a Federal system requires continual adjustment and readjustment. The spirit in which this continuous adjustment is to be undertaken is that of a desire to preserve such essential balance between central and local government as will prevent collapse of the Federal system, either through an enfeebling of the central or of the local units. This is, as Thompson points out, an intensely practical question, and not one of political philosophy or of constitutional law.

As a practical question, it involves the changing, complex relationships produced in an evolving, dynamic society. The right and the obligation of the States to grow, to develop, and to expand the scope and character of the services which they exist to render, under the Federal system, must be as fully recognized as the rights and the obligations of the Central Government. Hence the only proper attitude that can be taken by those who desire to see the Federal experiment succeed is that the processes of adjustment must go forward in a spirit of cooperation between the two grades of governmental jurisdiction.

Cooperation is never successful when one of the parties always yields, while the other never does. Such a policy quickly ceases to be cooperation. The unyielding disposition of the Federal Government has been commented upon many times, and there can be no question that such cooperation as may have been achieved with the States has been, in fact, a steady relinquishment of State responsibilities into Federal hands. That is, it has been a course of steady Federal encroachment upon the States.

Nowhere is the process of Federal encroachment upon the States more evident, or its effects more disastrous, than in the field of finance. Federal absorption of the income-tax field has already been mentioned. The later estate-tax acts may also be cited, for they impose exactions in which the States do not share, since the State proportion is definitely limited by the act of 1926. Now a further advance is proposed, namely, that of extending the Federal income tax to the interest which the States and their subdivisions pay on their bonds.

The reason for regarding this proposal with concern is that the move would be a direct handicap upon the performance of all State and local services by altering the terms and conditions under which these services are performed, insofar as it is necessary to rely upon public credit resources for the task. In the Department of Justice White book the position is taken that the effects of Federal taxation of State bond interest are purely conjectural. The following passage continues the expression of that viewpoint.[3]

"And assuming that income taxation would make the State bonds a less attractive investment, it is a matter of pure speculation as to how far this would be reflected in the price bid for the bonds. The investor would have no alternative market in which to acquire tax-exempt securities, and the greater safety of the State and municipal bonds might well result in their selling at a premium substantially equivalent to that which now can be obtained. These conclusions are reinforced when it is considered that under a progressive income tax the tax-exempt feature is the most valuable to the investors whose incomes are in the upper brackets. But the price of the bonds may be supposed to be set not by these investors but by the 'marginal' investors, those purchasers who are willing to pay no more than the smallest price at which the bonds will sell. These investors, ordinarily having smaller incomes, get no such disproportionate benefits from the tax immunity as do those in the upper income brackets."

It is doubtful if there exists anywhere an argument written to prove the con-

[3] Op. cit. p. 60.

jectural character of another statement which contains more and purer conjectures than are found in the passage just quoted. Thus, after granting that the tax would make the State bond a less attractive investment, it is conjectured that the premium offered for it would be just as high as at present, because other equally attractive investments could not be found. The analysis of estate tax returns presented in Appendix D indicates that investors do regularly find other investments for a very large proportion of their funds, and it is the purest conjecture to assume that they would blindly continue to buy State bonds on the same relative yield basis as now prevails.

The distribution of reported holdings of the partially exempt Federal securities refutes the guess that investors would be just as keen for the State bonds without the tax immunity. The Federal securities are fully as desirable, from the standpoint of safety and liquidity as are the State and local bonds, but very few of them are to be found, apparently, in the large-income brackets. What other reason could there be except the difference in taxable status?

Again, after pointing out the obvious fact that the exemption feature is worth more as a tax saving to those with large than with small incomes, it is assumed that the prices of State and local bonds are set by the small investors. Where could one find purer guesswork than this? It is obvious that those to whom the exemption, as such, may be worth most will be prepared to pay more than anyone else, but it is also equally clear that they do not always have to pay all that it is actually worth. They get what they want before this price is reached. The fact that they do not proceed to liquidate all other assets in order to own tax-exempt bonds exclusively explains why it is that other investors are also able to acquire some of these bonds. It is absurd to contend that those for whom ownership of such bonds involves an income loss greater than would be sustained if they were to buy other securities and pay income taxes would deliberately bid the prices of exempt bonds to levels at which they suffer a relative income loss unless they had to do this in order to get them. Yet this must be assumed if it be held, as is done in the foregoing extract, that the small investors fix the prices for these bonds by their bidding.

This extract has been commented upon at length because the document in which it occurs contains an argument, submitted by the Department of Justice, to prove that action should be taken at once, by legislation, to tax the interest on State and local bonds and the salaries of State and local employees and officers. It is therefore a sample of the attitude, and the kind of procedure, which have contributed so greatly to the expansion of the Federal powers at the expense of the States. It deserves citation here, not on the merit of its argument but as typical of the passing of that spirit of cooperation which is essential to the life of the Federal experiment.

It was pointed out at the beginning of this report that none of the effects, whether upon the revenues or upon the interest costs, that are submitted as estimated results of a removal of the tax immunity, will be fully apparent until after the emergence of a new mass of debt subject to taxation. If this should require 30 or 40 years, it will be that long before the State and local taxpayers are feeling the full effects of whatever increased load may be in store for them. It will be that long before the Federal revenues are enlarged by so much as may be expected. It will be that long before the progressive principle of taxation is fully vindicated through universal application.

To those who say that since it will take so long before the alleged reforms are fully operative, it would be best to get at the job without delay, the answer is, and that answer is made here: For the very reason that it will take so long before either the good or the bad effects can be ascertained, it is of the greatest importance that time enough be devoted now to putting such change as the people may want to approve upon a definite constitutional basis by appropriate amendment It will be too late for any drawing back if, after 40 years, the States find that they have lost more than the Federal Government has gained. For this reason alone they should have the opportunity of deciding, through the mechanism of ratifying an amendment, whether they are willing to take that chance.

Action by the amendment process has the further supreme merit of the cooperative method. The States will thereby participate in authorizing and sanctioning a change which will be of great importance to them. They will not have this change forced upon them, as is proposed in the document last cited above. The amendment process recognizes fully the empirical character of the Federal system and it is the most significant method of making the needed large-scale adjustments which this system requires for its success. Since it will be 40 years before all of the effects of any change can be registered, there can be no plea of great emergency to justify a refusal to approach the problem in an orderly and dignified manner.

APPENDIXES

APPENDIX A

	Date	Dealers													Insurance companies			
		A	B	C	D	E	F	G	H	I	J	K	L[1]	M[1]	1	2	3	4
State of California 3's	Feb. 1, 1950	70	25	35	45	45	75	95	45	80	74	45	------	------	35	70	44	1.05
State of California 4¼'s	July 3, 1957	70	30	45	25	50	50	1.00	40	80	50	40	------	------	25	75	55	90
Denver, Colo. 3¼'s	Oct. 1, 1964–65	80	25	55	45	45	65	95	55	95	75	65	------	------	70	95	45	1.05
Hart. Co. Metro. Dist. Com. 2¼'s	July 1, 1967	80	25	60	50	50	70	95	50	80	1.00	50	------	------	60	90	33	80
State of Illinois 4's	May 1, 1958	80	25	40	65	50	60	95	50	75	75	50	------	------	50	1.00	51	1.00
Indianapolis 2's	July 1, 1956	75	25	45	50	50	60	1.00	50	75	65	50	------	------	60	85	30	1.00
Baltimore, Md. 4's	Mar. 1, 1963	75	25	55	35	45	60	95	55	75	85	45	------	------	80	95	49	75
State of Massachusetts registered 4's	Aug. 1, 1953	80	25	40	50	45	70	80	60	1.00	60	50	------	------	50	70	52	80
State of Missouri 4¼'s	June 1, 1956	85	25	40	45	45	65	85	45	1.05	95	55	------	------	60	95	54	95
State of New Jersey 4½'s	July 1, 1963	70	25	40	35	60	60	80	60	1.00	70	40	------	------	60	1.10	54	80
State of New York registered 3's	July 1, 1958	75	25	35	35	40	70	75	40	90	60	40	------	------	60	75	42	75
New York City 4¼'s	Mar. 1, 1964	90	40	55	45	70	50	1.20	20	70	95	45	------	------	40	80	58	50
Scarsdale, N. Y. 4¼'s	July 1, 1957	70	30	65	45	45	60	95	45	95	70	50	------	------	65	95	54	70
Syracuse, N. Y. 3¾'s	Mar. 1, 1948	70	20	55	50	45	50	45	60	95	45	50	------	------	45	45	51	1.00
State of North Carolina 4½'s	Jan. 1, 1961	80	30	60	40	55	50	75	40	65	80	40	------	------	70	1.10	57	70
Charlotte, N. C. 3's	Feb. 1, 1967	90	40	60	30	70	50	95	50	65	1.20	70	------	------	80	1.00	44	85
Cincinnati, Ohio 2½'s	Sept. 1, 1961	75	25	40	35	40	60	85	50	75	80	50	------	------	1.00	65	33	90
State of Pennsylvania 5's	Aug. 2, 1951	75	20	40	50	45	65	80	40	1.25	75	45	------	------	45	40	62	75
Allegheny County, Pa. 2¾'s	June 1, 1962	65	40	45	40	45	55	90	35	65	65	40	------	------	60	40	37	1.05
Philadelphia 3¼'s	July 1, 1956–56	1.20	40	45	60	70	50	1.35	50	75	1.35	40	------	------	60	85	48	75
Providence, R. I. 1¾'s	Sept. 1, 1958	70	25	35	45	35	70	80	50	1.00	50	50	------	------	70	85	26	80
State of South Carolina 2¾'s	Oct. 1, 1954	80	40	40	50	60	50	65	50	1.00	50	50	------	------	40	65	41	1.10
State of Tennessee 3½'s	Oct. 1, 1956	95	40	40	30	50	50	1.20	45	80	35	30	------	------	40	60	50	90
Memphis, Tenn. 2.90's	Apr. 1, 1962	1.10	40	50	55	55	50	1.30	55	90	40	55	------	------	80	90	43	80
Dallas, Tex. 2¼'s	Aug. 1, 1958	70	40	50	45	45	60	1.20	60	95	60	40	------	------	90	80	34	95
Richmond, Va. 4½'s	Jan. 1, 1958	80	30	35	30	50	55	1.05	55	1.10	65	60	------	------	90	80	56	70
State of Virginia 2¼'s	July 1, 1953	75	25	35	50	50	85	85	50	95	75	50	------	------	95	65	35	85
Average		79.8	29.8	45.9	43.7	50.1	59.8	93.3	48.3	86.8	72.2	48.0	35	1.00	62.2	79.1	45.8	85.7

[1] No estimates of individual issues.

APPENDIX B

LIST OF BONDS USED IN MOODY'S BOND AVERAGES AS OF NOVEMBER 18, 1938

Railroads. Rating Aaa

Atchison, Topeka & Santa Fe general 4's, 1995.
Atchison, Topeka & Santa Fe Trans. S. L. 4's, 1958.
Chesapeake & Ohio 4¼'s, 1992.
Chicago Union Station 3¾'s, 1963.
Cincinnati Union Terminal 3½'s, 1971.
Hocking Valley 4½'s, 1999.
Norfolk & Western 4's, 1996.
Pennsylvania 4½'s, 1960.
Union Pacific 4's, 2008.

Public utilities. Rating Aaa

Cincinnati Gas & Electric 3¼'s, 1966.
Duquesne Light 3½'s, 1965.
Illinois Bell Telephone 3½'s, 1970.
New England Telephone & Telegraph 4½'s, 1961.
New York Edison 3¼'s, 1965.
New York & Queens Electric Light & Power 3½'s, 1965.
Pacific Telephone & Telegraph "B" 3¼'s, 1966.
Philadelphia Electric 3½'s, 1967.
Southwestern Bell Telephone 3's, 1968.
West Penn Power 3½'s, 1966.

Industrials. Rating Aaa

Liggett & Myers 5's, 1951.
Socony-Vacuum 3½'s, 1950.
Standard Oil of New Jersey 3's, 1961.

NOTE.—Because of the limited number of suitable issues, the railroad Aaa group now temporarily consists of nine issues, and the industrial Aaa group of three issues. Proper adjustments have been made in the averages, however, so that they remain comparable throughout.

LIST OF CITIES IN THE BOND BUYERS' INDEX OF FIRST GRADE MUNICIPAL CREDIT RATING

St. Louis, Mo.
Boston, Mass.
Baltimore, Md.
Pittsburgh, Pa.
Buffalo, N. Y.
San Francisco, Calif.
Los Angeles, Calif.
Milwaukee, Wis.
Cincinnati, Ohio.
Kansas City, Mo.
Minneapolis, Minn.

Monthly yield basis, Moody's triple A corporate bonds, the bond-buyer index for 11 cities, and average yield of outstanding Treasury bonds

Year	Treasury bonds	Municipal bonds	Corporate bonds	Year	Treasury bonds	Municipal bonds	Corporate bonds
1928				1930			
January	3.18	3.83	4.46	January	3.43	4.19	4.66
February	3.19	3.83	4.46	February	3.41	4.25	4.69
March	3.17	3.83	4.46	March	3.29	4.21	4.62
April	3.20	3.85	4.46	April	3.36	4.10	4.60
May	3.24	3.87	4.49	May	3.30	4.12	4.60
June	3.29	3.97	4.57	June	3.24	4.13	4.57
July	3.42	4.02	4.61	July	3.23	4.07	4.52
August	3.49	4.12	4.64	August	3.25	4.02	4.47
September	3.46	4.15	4.61	September	3.23	3.96	4.42
October	3.48	4.12	4.61	October	3.20	3.92	4.42
November	3.39	4.12	4.58	November	3.17	3.93	4.47
December	3.46	4.08	4.61	December	3.20	4.00	4.52
1929				1931			
January	3.52	4.13	4.62	January	3.17	4.05	4.42
February	3.62	4.17	4.66	February	3.27	3.98	4.43
March	3.74	4.23	4.70	March	3.26	3.95	4.39
April	3.63	4.31	4.69	April	3.24	3.82	4.40
May	3.64	4.23	4.70	May	3.13	3.75	4.37
June	3.69	4.27	4.77	June	3.10	3.60	4.36
July	3.64	4.30	4.77	July	3.11	3.70	4.36
August	3.70	4.30	4.79	August	3.13	3.70	4.40
September	3.68	4.40	4.80	September	3.24	3.70	4.55
October	3.68	4.47	4.77	October	3.62	3.88	4.99
November	3.36	4.33	4.76	November	3.59	4.11	4.94
December	3.37	4.26	4.69	December	3.92	4.23	5.32

Monthly yield basis, Moody's triple A corporate bonds, the bond-buyer index for 11 cities, and average yield of outstanding Treasury bonds—Continued

Year	Treasury bonds	Municipal bonds	Corporate bonds
1932			
January	4.32	4.66	5.20
February	4.11	4.65	5.23
March	3.91	4.61	4.98
April	3.66	4.40	5.17
May	3.71	4.30	5.36
June	3.73	4.42	5.41
July	3.55	4.46	5.26
August	3.42	4.25	4.91
September	3.38	4.08	4.70
October	3.39	4.02	4.64
November	3.39	4.04	4.63
December	3.31	4.04	4.59
1933			
January	3.19	3.81	4.44
February	3.20	3.88	4.48
March	3.44	4.26	4.68
April	3.43	4.44	4.78
May	3.31	4.90	4.63
June	3.22	4.48	4.46
July	3.20	4.30	4.36
August	3.21	4.20	4.30
September	3.20	4.12	4.36
October	3.22	4.20	4.34
November	3.46	4.26	4.54
December	3.53	4.64	4.50
1934			
January	3.50	4.50	4.35
February	3.32	4.06	4.20
March	3.21	3.99	4.13
April	3.01	3.60	4.01
May	3.12	3.84	4.07
June	2.94	3.01	3.93
July	2.85	3.49	3.80
August	2.99	3.50	3.93
September	3.20	3.60	3.96
October	3.08	3.67	3.90
November	3.05	3.42	3.86
December	2.97	3.38	3.81
1935			
January	2.83	3.30	3.77
February	2.73	3.19	3.69
March	2.69	3.15	3.67
April	2.64	2.90	3.66
May	2.61	2.93	3.65
June	2.61	2.98	3.61
July	2.59	2.85	3.56
August	2.66	2.81	3.60
September	2.78	2.94	3.59
October	2.77	3.10	3.52
November	2.73	2.95	3.47
December	2.73	2.79	3.44
1936			
January	2.68	2.84	3.37
February	2.62	2.73	3.32
March	2.54	2.66	3.29
April	2.51	2.69	3.29
May	2.50	2.76	3.27
June	2.50	2.61	3.24
July	2.50	2.66	3.23
August	2.43	2.60	3.21
September	2.41	2.59	3.18
October	2.42	2.53	3.18
November	2.29	2.54	3.15
December	2.27	2.35	3.10
1937			
January	2.20	2.35	3.10
February	2.31	2.49	3.22
March	2.50	2.63	3.32
April	2.74	2.90	3.42
May	2.67	2.81	3.33
June	2.64	2.77	3.28
July	2.59	2.70	3.25
August	2.59	2.62	3.24
September	2.67	2.60	3.28
October	2.65	2.69	3.27
November	2.60	2.70	3.24
December	2.54	2.74	3.21
1938			
January	2.47	2.75	3.17
February	2.40	2.66	3.20
March	2.45	2.61	3.22
April	2.43	2.72	3.30
May	2.30	2.61	3.22
June	2.31	2.58	3.26
July	2.34	2.51	3.22
August	2.32	2.49	3.18
September	2.40	2.51	3.21
October	.....	2.57	3.15

APPENDIX C

LIST OF MUNICIPAL BONDS USED IN THE MUNICIPAL CREDIT INDEX PREPARED BY STANDARD STATISTICS, INC.

Baltimore, 3½'s, 1945.
Boston, 3½'s, 1945.
Buffalo, 4's, 1960.
Chicago, 4's, 1939.
Cleveland, 4¼'s, 1938.
Cincinnati, 4½'s, 1955.
Detroit, 4¼'s, 1952.
Los Angeles, 4's, 1945.
Milwaukee, 5's, 1940.
Minneapolis, 4's, 1944.
Newark, 4's, 1961.
New York (Rapid Transit), 3½'s, 1950.
Philadelphia, 4's, 1966.
Pittsburgh, 4½'s, 1950.
St. Louis, 4½'s, 1938.

Average bond yields as computed by Standard Statistics, Inc.

	15 first-grade municipal bonds	Industrial A1+ bonds	Railroad A1+ bonds	Public utilities A1+ bonds	Average, all A1+ corporation bonds
1936					
January	3.27	3.39	3.47	3.38	3.41
February	3.22	3.36	3.45	3.32	3.38
March	3.18	3.36	3.42	3.29	3.36
April	3.17	3.33	3.38	3.25	3.32
May	3.16	3.37	3.39	3.23	3.33
June	3.16	3.37	3.39	3.21	3.32
July	3.13	3.33	3.33	3.21	3.29
August	3.06	3.31	3.35	3.21	3.29
September	2.07	3.30	3.32	3.18	3.27
October	2.94	3.29	3.29	3.15	3.24
November	2.85	3.28	3.27	3.16	3.24
December	2.76	3.20	3.20	3.12	3.17
1937					
January	2.79	3.20	3.28	3.07	3.18
February	2.96	3.17	3.30	3.08	3.18
March	3.19	3.26	3.37	3.09	3.24
April	3.24	3.37	3.50	3.22	3.36
May	3.14	3.44	3.55	3.23	3.41
June	3.11	3.34	3.45	3.16	3.31
July	3.07	3.28	3.51	3.14	3.31
August	3.01	3.25	3.41	3.10	3.25
September	3.18	3.30	3.45	3.08	3.28
October	3.24	3.34	3.49	3.10	3.31
November	3.17	3.53	3.51	3.13	3.39
December	3.15	3.49	3.58	3.07	3.38
1938					
January	3.03	3.32	3.49	2.96	3.26
February	2.99	3.25	3.52	2.95	3.24
March	2.99	3.05	3.43	2.91	3.13
April	3.03	3.17	3.64	2.91	3.24
May	2.91	3.11	3.60	2.92	3.21
June	2.91	3.08	3.60	2.89	3.19
July	2.87	3.17	3.66	2.89	3.24
August	2.82	3.05	3.58	2.87	3.17
September	----------	3.07	3.53	2.79	3.13

APPENDIX D

Amounts of certain investments in estate tax returns 1926–36 by size of net estate

[Money figures in thousands of dollars]

	No net taxable estate 1925-31	No net taxable under 1926 act but taxable later act	Under 50	50–100	100–200
Number of returns	20,003	23,997	21,276	10,349	10,191
Federal bonds:					
Wholly exempt	9,571	12,714	17,749	17,123	28,695
Partly exempt	32,896	76,811	90,561	61,514	84,509
State and local bonds	31,618	44,329	68,491	54,870	104,418
All other bonds	122,227	109,867	270,519	205,526	295,529
Capital stock	589,089	538,937	972,873	757,557	1,163,026
Total gross estate	2,377,570	2,054,300	3,237,819	2,247,091	3,137,612
	Percent of each type of investment to gross estate				
Federal bonds:					
Wholly exempt	0.40	0.62	0.55	0.76	0.91
Partly exempt	1.38	3.74	2.80	2.74	2.69
State and local bonds	1.33	2.16	2.12	2.44	3.33
All other bonds	5.14	8.27	8.63	9.16	9.42
Capital stock	24.78	26.23	30.05	33.71	37.07

Appendix D—Continued

Amounts of certain investments in estate tax returns 1926–36 by size of net estate—Continued

[Money figures in thousands of dollars]

	No net taxable estate 1926-31	No net taxable under 1926 act but taxable later act	Under 50	50-100	100-200
	200-400	400-600	600-800	800-1,000	1,000-1,500
Number of returns	7,854	3,133	1,672	974	1,273
Federal bonds:					
Wholly exempt	47,200	37,709	31,726	27,283	58,254
Partly exempt	86,783	51,493	35,958	19,711	35,849
State and local bonds	158,155	125,053	107,517	98,869	174,189
All other bonds	344,946	215,121	130,533	95,290	146,044
Capital stock	1,545,552	1,029,773	745,502	597,952	980,994
Total gross estate	3,740,648	2,316,080	1,625,968	1,232,398	2,039,837
	Percent of each type of investment to gross estate				
Federal bonds:					
Wholly exempt	1.26	1.63	1.95	2.21	2.88
Partly exempt	2.32	2.22	2.22	1.60	1.76
State and local bonds	4.23	5.40	6.61	8.02	8.54
All other bonds	9.22	9.29	8.03	7.73	7.20
Capital stock	41.32	44.46	45.85	48.52	48.53

	1,500-2,000	2,000-2,500	2,500-3,000	3,000-3,500	3,500-4,000	4,000-5,000
Number of returns	594	323	203	141	110	123
Federal bonds:						
Wholly exempt	46,068	34,343	30,891	18,318	18,010	24,313
Partly exempt	17,420	15,146	10,584	4,286	4,279	6,502
State and local bonds	118,363	96,316	81,097	59,369	65,571	64,827
All other bonds	77,661	49,178	36,093	22,440	18,707	26,367
Capital stock	695,335	484,586	341,021	292,845	291,481	359,383
Total gross estate	1,318,674	936,690	693,143	530,718	504,825	652,634
	Percent of each type of investment to gross estate					
Federal bonds:						
Wholly exempt	3.49	3.67	4.46	3.45	3.57	3.75
Partly exempt	1.32	1.62	1.53	.80	.85	1.00
State and local bonds	8.98	10.28	11.83	11.19	12.99	9.93
All other bonds	5.89	5.25	5.21	4.23	3.72	4.04
Capital stock	52.73	51.72	49.20	55.20	57.94	54.91

	5,000-6,000	6,000-7,000	7,000-8,000	8,000-9,000	9,000-10,000	10,000 and over
Number of returns	80	50	32	25	13	87
Federal bonds:						
Wholly exempt	19,629	17,581	21,897	9,930	3,113	87,650
Partly exempt	3,966	1,308	1,786	270	170	17,490
State and local bonds	76,509	27,763	44,674	57,046	4,930	167,170
All other bonds	24,133	16,154	8,111	9,791	958	71,374
Capital stock	284,125	241,461	165,471	142,436	111,195	1,446,505
Total gross estate	563,605	410,724	297,192	267,786	153,910	2,223,357
	Percent of each type of investment to gross estate					
Federal bonds:						
Wholly exempt	3.48	4.28	7.37	3.71	2.02	3.95
Partly exempt	.70	.32	.60	.10	.11	.79
State and local bonds	13.57	6.76	15.03	21.30	3.20	7.55
All other bonds	4.28	3.93	2.73	3.66	.62	3.22
Capital stock	50.41	58.79	55.67	53.19	72.24	65.35

APPENDIX E

ESTIMATED AMOUNT OF STATE AND FEDERAL INTEREST RECEIVED BY CORPORATIONS IN 1937

The latest issue of the official publication, Statistics of Income, part II, which deals with the corporation returns, is for the year 1935. The usual preliminary summary of corporate returns for 1936 has just been published (December 1938). Data are given in the complete annual reports to show the total principal holdings of tax-exempt securities, and in both preliminary and final annual reports to show the interest received by corporations from their tax-exempt investments, but neither report segregates principal or interest as between Federal and State obligations. It becomes necessary to make an apportionment on the basis of such information as is available regarding this distribution.

For 1935 the corporations submitting balance sheets reported total tax-exempt investments, and interest thereon, as follows: [4]

Principal of tax-exempt investments reported by corporations in 1935, and interest received thereon

Category	Corporations having net income	Corporations having no net income	Total
Principal amounts	$5,036,700,000	$16,826,500,000	$21,863,200,000
Interest received in 1935	197,400,000	516,100,000	713,500,000

The first task is to arrive at an estimate of the total corporate holdings as of 1937 and to make some sort of apportionment of the total as between Federal and State securities. The Treasury Gray Book gave the following holdings of the principal classes of corporations, as of varying dates: [5]

Reported corporate holdings of Federal and State bonds

Date	Class of corporation	Federal bonds	State bonds
June 30, 1937	Banks	$14,916,000,000	$2,769,000,000
Dec. 31, 1937	Life-insurance companies	4,416,000,000	1,424,000,000
Dec. 31, 1936	Other insurance companies	835,000,000	322,000,000
Dec. 31, 1935	Nonfinance corporations	1,767,000,000	353,000,000

It remains to bring some of these data down to 1937. The following tabulation is submitted as an assumption of what may have been the actual holdings of corporations in Federal and State securities in 1937:

Date	Class of corporation	Federal	State	Total
June 30, 1937	Banks	$14,916,000,000	$2,769,000,000	$17,685,000,000
Dec. 31, 1937	Life insurance companies	4,416,000,000	1,424,000,000	5,840,000,000
Do	Insurance companies other than life companies	900,000,000	400,000,000	1,300,000,000
Do	Nonfinance corporations	1,850,000,000	450,000,000	2,300,000,000
Estimated totals, as of 1937		22,082,000,000	5,043,000,000	27,125,000,000

Since the total corporate holdings as of December 31, 1935, were $21,863,000,000, the above estimate for 1937 means an acquisition, over 2 years, of some $5,250,000,000. In 1934 the total corporate holdings of tax-exempt securities increased by $5,400,000,000. They increased by $2,700,000,000 in 1935.[6] The yield data given in appendix A indicate that 1937 was a better year for the acquisition of these securities than either 1935 or 1936, and it is not unreasonable to assume such an increase in these investments as is given above.

[4] Statistics of Income, pt. II, 1935, table 5. The document contains conflicting figures as to the amount of exempt interest received, but the preliminary report for 1936 confirms one set found in the 1935 report, and those figures are used here. Cf. table 3 of the 1935 report, and table 2 of the 1936 preliminary report.

[5] Op. cit., p. 113.

[6] Compare Statistics of Income pt. II, 1935.

The next step, and a more difficult one, is to apportion the total corporate receipts of tax-exempt interest as between Federal and State securities. On the basis of the trend of these receipts, and of the estimated total holdings of tax-exempt securities as of 1937, the total corporate receipts of tax-exempt interest for 1936 and 1937 are estimated as follows: [7]

Year:	*Total corporate receipts of tax-exempt interest*
1933	$591,600,000
1934	658,700,000
1935	713,500,000
1936	[1] 735,000,000
1937	[1] 765,000,000

[1] Estimated.

The preliminary Statistics of Income for 1936 reported total corporate receipts of tax exempt interest of $723,200,000 for that year. In view of the relative upward revision of the corresponding figure between the preliminary and the final reports for 1935, it is assumed that the final figure for 1936 may be as high as $735,000,000 and that the 1937 figure may be $765,000,000.

None of the published statistical surveys give any hint as to the distribution of corporate interest receipts as between Federal and State securities. The allocation made here is put forward only as an approximate one, since it is made by a series of inferences.

In table VI, it is shown that the total of State and local bonds in possession of all classes of investors subject to income tax was $13,516,000,000 in 1937, and that the total of State and local interest received by these taxable investors in that year was $562,400,000. Here it is estimated that the corporate holdings of State and local securities in 1937 totaled $5,043,000,000, which was 37.3 percent of the total held by all taxable investors. A proportionate share of the total State and local interest received by taxable investors would have given the corporations $209 770,000.

In the table given on page 173 above, the total of the State and local securities estimated to have been held by corporations in 1937 was 18.5 percent of the total holdings of tax-exempt securities. Apportioning the estimated total corporate receipts of tax-exempt interest, namely $765,000,000, on the same basis, would produce $141,500,000 as the amount of State interest. This method doubtless weights too heavily the Federal securities, in view of the large amounts of low-yield paper held by the banks and other classes of corporate investors.

A third approach to the problem is found in the fact that in appendix F it is shown that the total amount of Federal securities in the possession of investors subject to income tax in 1937 was $35,550,000,000. The estimated corporate holdings in 1937 were 62.1 percent of this total. Apportioning the total Federal interest paid to the various categories of taxable investors on the same basis, a total of $524,000,000 is found to be the corporate share. Deducting this from the estimated total of corporate tax-exempt interest, the amount of State interest received by corporations would have been $241,000,000.

None of these methods is definitely reassuring. An average of the three results may be no more reassuring. Such an average is $197,432,000. This is rounded off to $200,000,000, as a rather arbitrary apportionment of the amount of interest received by corporations on their holdings of State and local debt in 1937. Therefore, their receipts of Federal interest in that year were $565,000,000.

The number of corporations which will report no net income in any year, and their relative importance for the income tax, are directly dependent upon the course of business activity. In this report it has been assumed that year by year only 60 percent of the interest on public securities will be received by corporations which report net income. Actually, this proportion will vary from one year to another, and the fact that interest on public securities is to be treated as taxable income will cause some change of status over what it would have been had that interest continued to be exempt from taxation.

The selection of the ratio of 60 percent was made after consideration of the record of the 10 years 1927 to 1936, inclusive. This record is summarized in table XXII.[8]

[7] Corporate interest receipts for 1933-35 from Statistics of Income, pt. II, 1935.

[8] Statistics of Income for 1936, Preliminary report of corporation income and excess-profits tax returns filed in period January through December 1937, p. 9.

TABLE XXII.—*Total interest on Government obligations reported by corporations with, and without, net income, respectively*

Year	Interest on public debt reported by corporations having net income		Interest on public debt reported by corporations having no net income	
	Amount	Percent of total	Amount	Percent of total
1927	$409,630,000	81.7	$92,105,000	18.3
1928	417,082,000	79.8	105,476,000	21.2
1929	431,039,000	80.2	105,658,000	19.8
1930	349,442,000	66.4	176,818,000	33.6
1931	215,978,000	39.8	325,735,000	61.2
1932	147,468,000	26.6	406,782,000	73.4
1933	154,209,000	26.0	437,287,000	74.0
1934	197,582,000	30.0	461,119,000	70.0
1935	197,446,000	27.6	516,101,000	72.4
1936	487,330,000	67.3	235,915,000	32.7
Total	3,007,196,000	51.2	2,863,086,000	48.8

The effects of the economic cycle are obvious in the above table, for in the prosperous years the corporations with no net income will report only about one-fifth of the total Government interest receipts of all corporations, while in the depression years, they will report upward of three-quarters of the total. For the 10 years the average was almost an even distribution between the corporations with and without net income, respectively. It was assumed that on the average, 60 percent would be a fair proportion to use in imputing taxable Government interest to the corporations that will report net income.

APPENDIX F

METHODS USED TO ESTIMATE THE OWNERSHIP DISTRIBUTION OF FEDERAL SECURITIES AND INTEREST

The taxation status of the debt obligations issued by the Federal Government and its agencies, as of June 30, 1937, was as follows: [9]

TABLE XXIII.—*Tax status of principal and interest of the debt of the Federal Government and its agencies, June 30, 1937*

Debtor agency	Principal		Interest	
	Wholly exempt	Partially exempt [1]	Wholly exempt	Partially exempt [1]
United States	$15,065,000,000	$20,738,000,000	$288,000,000	$636,000,000
Federal agencies	2,228,000,000	8,319,000,000	76,000,000	148,000,000
Total	17,293,000,000	29,057,000,000	364,000,000	784,000,000

[1] Partially exempt means exempt from normal tax.

The character of this debt, classified according to the debtor agency, is shown in further detail in the table which follows: [10]

[9] Figures are from Treasury Grey Book, pp. 11, 12.
[10] Op. cit., p. 18.

TABLE XXIV.—*Debt of the Federal Government and its agencies, according to the borrowing authority, June 30, 1937*

Borrowing agency	Amount	
	Wholly exempt	Partially exempt
U. S. Government bonds	$1,086,500,000	$20,737,800,000
Treasury notes	11,325,200,000	
Treasury certificates and bills	2,652,900,000	
Total, U. S. Government obligations	15,064,700,000	20,737,800,000
Federal agencies:		
Reconstruction Finance Corporation notes		3,560,000,000
Federal Farm Mortgage bonds		1,422,000,000
Federal Land Bank bonds	1,868,600,000	
Federal Intermediate Credit Bank debentures	180,000,000	
Joint Stock Land Bank bonds	179,000,000	
Home Owners' Loan Corporation bonds		3,012,000,000
Total Federal agencies	2,227,600,000	8,319,100,000
Grand total	17,293,200,000	29,056,900,000
Combined aggregate	$46,350,200,000	

The wholly tax-exempt issues of the Federal Government and its agencies constitute 37.1 percent of the combined aggregate. The amount of interest that is wholly exempt from Federal income tax is 31.79 percent of the total interest paid on these obligations. The disproportion is caused by the abnormally low interest cost of the Treasury bills and certificates.

(a) *Federal securities held by public funds and agencies.*—The first step in the estimation of the distribution of Federal securities and interest is to apportion the whole as between the public funds and agencies, on one hand, and the private investors on the other. As of June 30, 1937, the following amounts were held by public trust and investment funds, including the Federal Reserve banks: [11]

TABLE XXV.—*Amounts and proportions of Federal securities held by public funds and agencies, as of June 30, 1937*

Borrowing agency	Gross total of securities outstanding	Amount held by public funds and agencies	Percent of ratio
U. S. Government	$35,803,000,000	$5,966,500,000	16.6
Federal agencies	10,547,000,000	4,835,000,000	45.8
Total	46,350,000,000	10,801,500,000	23.3

(b) *Federal interest received by public funds and agencies.*—The next step is to apportion the Federal interest paid in 1937 as between the public funds and agencies, on one hand, and private investors on the other. The proportions of the wholly exempt and partially exempt bonds, respectively, that are held by public funds and agencies are given in table XXVI.[12]

TABLE XXVI.—*Amount and proportion of wholly and partially tax-exempt Federal bonds, respectively, in public accounts, as of June 30, 1937*

Borrower	Wholly exempt amount in trust and investment			Partially exempt amount in trust and investment		
	Total issue	Funds	Ratio	Total issue	Funds	Ratio
			Percent			Percent
U. S. Government	$15,065,000,000	$3,465,000,000	23.0	$20,738,000,000	$2,501,300,000	12.0
Federal agencies	2,228,000,000	834,900,000	37.4	8,319,000,000	4,000,000,000	48.0

[11] Idem., pp. 36 and 49.
[12] Idem., p. 74.

From the ratios obtained in the above table, showing the relative distribution of principal holdings by taxation status thereof, a corresponding apportionment of Federal interest as between public funds and agencies, on one hand, and private investors, on the other, may be calculated. This apportionment is shown in table XXVII.[13]

TABLE XXVII.—*Total interest on Federal obligations, as of 1937, and apportionment thereof between public investment funds and private investors*

Debtor agency	Total interest paid in 1937	Interest paid to public funds etc.		Balance of interest paid to private investors		
		Percent of total	Amount	Amount	Total wholly exempt	Total partially exempt
U. S. Government:						
Wholly exempt	$288,000,000	23	$66,200,000	$221,800,000	.....	.....
Partially exempt	636,000,000	12	76,300,000	559,700,000	.....	.....
Federal agencies:						
Wholly exempt	76,000,000	37.4	28,400,000	47,600,000	.....	.....
Partially exempt	148,000,000	48	71,000,000	77,000,000	$269,400,000	$636,700,000
Totals	1,148,000,000	.....	241,900,000	906,100,000	.....	.....

The result of this adjustment shows that in 1937 private investors received $269,400,000 of wholly exempt Federal interest, and $636,700,000 of interest that was partially exempt. The total Federal interest paid to all classes of private investors as of 1937 was therefore $906,100,000.

This total must be further reduced by an allowance for the interest received by tax-exempt institutions. No adjustment on this account was possible in the above tables, since the distribution of these holdings as between wholly exempt and partially exempt bonds is unknown. As of June 30, 1937, the mutual savings banks held $2,400,000,000 of Federal bonds. To this amount must be added the estimated holdings of Federal debt by fraternal benefit societies, foundations and universities, amounting in all to about $125,000,000. The total deduction of principal holdings on account of exempted institutions would therefore be $2,525,000,000,000. On a pro rata basis, the interest received by these institutions in 1937 was $62,300,000. Deduction of this amount from the total of interest estimated to have been received by private investors would leave $843,800,000 of Federal interest received in 1937 by investors who would have been subject to Federal tax had all exemption provisions been eliminated at that time.

2. *Ownership distribution of taxable Federal interest.*—The total taxable Federal interest was received in part by individuals and in part by corporations. The receipts of Federal interest reported by individuals in 1936 are shown in table XXVIII.[14]

TABLE XXVIII.—*Federal interest reported by individuals in income-tax returns for 1936*

Category of taxpayer:	*Amount*
Individuals with net income of $5,000 and over:	
Wholly exempt interest	$42,499,000
Partially exempt interest	43,152,000
Individuals with no net income	1,322,000
Total Federal interest reported by individuals	86,973,000

Deduction of this amount from the total of taxable interest for 1937 leaves $756,900,000 of Federal interest, as of 1937, ownership of which is yet to be traced. On the basis of computations which are given in appendix E, it is estimated that the corporate share of the Federal interest paid in 1937 was $565,000,000 in round figures. This would leave some $191,900,000 of Federal interest for 1937 to be allocated to the net incomes of individuals.

[13] The distribution of Federal interest as between complete and partial exemption from income tax is taken from the Treasury Gray Book, p. 12. Elsewhere in this document estimates are presented of the amount of interest received by the various public investment funds which indicate that a total of $927,000,000 was paid to private investors in 1937. The estimate in the above table is $906,000,000. The difference is produced by an abnormally low estimate, in the Treasury Gray Book, for the interest receipts of public investment funds from the obligations issued by Federal agencies.

[14] Statistics of Income, pt. I, 1936, pp. 30, 31.

The apportionment of this sum can only be approximated. The Treasury Gray Book states that a special analysis of the tax returns for 1934 revealed ownership of some $827,000,000 of Federal securities in the net income groups below $5,000.[16] But by December 1937 the total of savings bonds issued was $1,368,000,000. An investigation among the holders of these bonds revealed that a large proportion had been bought by skilled workers and others of relatively modest incomes. Hence the assumption that a total of $1,300,000,000 of the Federal debt is allocable to the group of individuals with net incomes under $5,000, does not seem unreasonable. This assumption imputes the purchase of only $473,000,000 of the savings bonds by persons with a net income below $5,000, during the period in which the total of savings bonds issued was $1,368,000,000. In fact, it may be too low, considering the amount of Federal securities estimated to have been held by this group in 1934, and the total sales of savings bonds after the inauguration of this type in March 1935.

Since ownership of savings bonds involves an accrual of interest, it is proper to regard this accrual as an interest expense to the Treasury, and as an interest receipt by the holder of the bonds, although no cash is actually paid out. It is assumed, also, that the data used here relative to Federal interest costs include the accrued interest obligations on account of the savings bonds. While it is therefore proper to allocate a certain proportion of the interest costs as of 1937 to the net income group which is supposed to hold a considerable proportion of the savings bonds, it is misleading to regard all of such interest receipts as being, in fact, taxable in 1937. The ordinary holder of a savings bond will receive the entire interest for 10 years, in cash, when the matured bond is paid, and he will pay income tax on the whole amount of interest at that time. That is, he buys the bond at a discount, and its value increases, through the compounding of the accrued interest, until it is redeemed at par on the maturity date. The difference between the price originally paid and the final par value is the interest which the holder receives on his investment during the life of the bond. The interest accrual is computed at 2.9 percent, but if the holder wishes to redeem his bond before final maturity, his interest allowance is computed at a somewhat lower rate.

At final maturity, or at redemption, should this occur earlier at the holder's request, the interest earned is to be reported as income, and under the present law this interest is exempt from normal tax but is subject to surtax. Incidentally, this will come as quite a jolt to him when it happens, but as of 1937, however, there would be a discrepancy between the Treasury's record of interest costs, paid and accrued, and the aggregate of interest receipts by investors, since a very large proportion of the holders of savings bonds will not accrue as current income the amounts which their savings bonds have actually earned in the way of interest in 1937 or in any other year prior to maturity.

For the purposes of the present apportionment of the Federal interest payments in 1937, an average interest return of 2.6 percent is assumed to have been received on the $1,300,000,000 of principal allocated to the small income groups. The total interest payments thus allocated would be $33,800,000. Deducting this amount from the $191,900,000 which was to be apportioned among the different groups of individual investors, a remainder of $158,100,000 is obtained. This must be assigned to the individuals with net incomes of $5,000 and over, in addition to an amount equal to that reported by these individuals in 1936 as wholly exempt Federal interest. The total which must be dealt with in these income groups is therefore $200,600,000.

The amount here imputed to the larger individual incomes is undoubtedly in excess of the correct amount received, for it takes no account of foreign holdings of Federal debt, which may be substantial, and no account of the possible diffusion of this debt among other categories of investors than those covered by the surveys that have been made. The estimates of the probable tax yield will therefore be inflated accordingly, but it is impossible to suggest any appropriate standard for correcting them.

[16] Ibid., p. 101.

Comparison of estimated ownership, distribution of State and Federal securities, respectively, as given in the present report and as compiled by John W. Hanes, Under Secretary of the Treasury [1]

Category of ownership	Federal		State, local, and Territorial	
	The present report	Mr. Hanes' figures	The present report	Mr. Hanes' figures
Public investment and trust funds	$10,801,000,000	$10,800,000	$4,324,000,000	$4,300,000
Exempt institutions	2,525,000,000	2,900,000	1,458,000,000	1,300,000
Banks (except mutual savings banks)	14,916,000,000	14,900,000	2,769,000,000	2,800,000
Insurance companies	5,251,000,000	5,000,000	1,824,000,000	1,800,000
Other corporations	1,767,000,000	2,000,000	450,000,000	800,000
Individuals	11,090,000,000	10,700,000	8,473,000,000	8,300,000
Total	46,350,000,000	46,300,000	19,298,000,000	19,300,000

[1] Statement by John W. Hanes, Under Secretary of the Treasury, before the Special Committee of the Senate on Taxation of Governmental Securities and Salaries. Jan. 18, 1939.

APPENDIX G

METHODS USED TO ESTIMATE THE FEDERAL TAX YIELD ON INTEREST INCOMES IMPUTED TO INDIVIDUAL INCOMES OF $5,000 AND OVER

Since the number of individuals who may own Federal or State bonds is unknown, as is also the amount of each individual's holdings, it is necessary to approximate the tax yield on the basis of such data as are known regarding ownership distribution.

After much deliberation, it was decided that two rather indefinite clues were available as to the probable ownership distribution of Government securities by individuals, following the introduction or extension of the Federal tax. One of these is the distribution of interest receipts on United States Treasury bonds and other Federal debt obligations which are now subject to surtax. The actual receipts of such interest as reported by individuals with net incomes of $5,000 and over are published in the annual Statistics of Income, and in the calculations made in this report, the data reported for 1936 were used. The method of tax computation used simply reveals the revenue that might be expected, if the amount of State, or of Federal, interest respectively, which is imputed to these net income groups were actually received and were distributed proportionately as the reported partially exempt Federal interest is distributed.

This is in no sense an assumption that the receipts of Federal or of State interest will be so distributed, after the proposed tax changes become effective, nor is it in any sense a forecast of the future. No tax estimates can be made except on some assumption as to income distribution, and the reported receipts of partially exempt Federal interest reveal simply the investment policy of individuals with respect to certain classes of public debt.

The other clue as to individual ownership distribution is in the holdings of corporation bonds, as revealed by the analysis of estate tax data. For this purpose, the data given in appendix D were used, and the classification of estates by size groups was converted to a classification on an assumed net income basis of approximately 3 percent or thereabouts. The conversion could be only approximate, as the following tabulation shows:

Net estate brackets	*Corresponding net income brackets*
$200,000- $400,000	$5,000-$10,000
400,000- 800,000	10,000- 25,000
800,000- 1,500,000	25,000- 50,000
1,500,000- 3,000,000	50,000-100,000
3,000,000- 5,000,000	100,000-150,000
5,000,000-10,000,000	150,000-300,000
10,000,000 and over	300,000 and over

The analysis of the investments of estates, given in appendix D, extended to the private or taxable bonds. The aggregate of these bonds for all estates included in the above net-income brackets was distributed according to the relative net-estate brackets, and thus ratios were established for a distribution of taxable bond hold-

ings by equivalent net-income groups. This distribution and the ratios are as follows:

Net income brackets corresponding to certain net estate brackets	Aggregate taxable bonds in each net income bracket	Ratio of bonds in each bracket to total bonds in all estates
		Percent
$5,000 to $10,000	$344,946,000	21.67
$10,000 to $25,000	345,654,000	26.71
$25,000 to $50,000	242,234,000	18.72
$50,000 to $100,000	162,932,000	12.59
$100,000 to $150,000	67,574,000	5.22
$150,000 to $300,000	59,152,000	4.57
$300,000 and over	91,374,000	5.52
	1,293,866,000	100.00

This hypothesis involves the assumption that if all bonds which are now exempt or immune from the Federal income tax should, as a result of that tax, be distributed among the net-income brackets in the same manner as the taxable bonds now appear to be distributed, a basis is provided for estimating the amount of tax that would be collected from the interest therefrom. Accordingly, the amount of State and of Federal interest, respectively, that was imputed to the net incomes of $5,000 and over was fitted to the net-income brackets given above. In this case, however, the median surtax rates were used for each of the brackets, since the actual surtax scale contains many more subdivisions than it was possible to establish in dealing with the estate-tax data. The complete details of the distribution of imputed interest and of the calculation of tax thereon, are shown in the following tables:

TABLE XXIX.—*Distribution of State and Federal interest, respectively, as imputed to net incomes of $5,000 and over, and estimated taxes thereon*

Surtax brackets	Surtax rates	Distribution of imputed State interest, on the basis of reported partially exempt Federal interest	Estimated tax on imputed State interest	Distribution of imputed Federal interest, on the basis of reported partially exempt Federal interest	Estimated tax on imputed Federal interest
	Percent				
$5,000 to $6,000	4	$22,843,000	$914,000	$13,603,000	$544,000
$6,000 to $8,000	5	37,836,000	1,891,000	22,506,000	1,125,000
$8,000 to $10,000	6	29,813,000	1,788,000	17,737,000	1,064,000
$10,000 to $12,000	7	23,394,000	1,637,000	13,919,000	974,000
$12,000 to $14,000	8	22,800,000	1,824,000	13,565,000	1,085,000
$14,000 to $16,000	9	14,821,000	1,334,000	8,822,000	794,000
$16,000 to $18,000	11	13,706,000	1,507,000	8,163,000	897,000
$18,000 to $20,000	13	13,709,000	1,782,000	8,161,000	1,061,000
$20,000 to $22,000	15	10,990,000	1,648,000	6,426,000	964,000
$22,000 to $26,000	17	20,663,000	3,513,000	12,117,000	2,060,000
$26,000 to $32,000	19	22,911,000	4,353,000	13,432,000	2,552,000
$32,000 to $38,000	21	18,991,000	3,988,000	11,062,000	2,323,000
$38,000 to $44,000	24	12,528,000	3,007,000	7,453,000	1,791,000
$44,000 to $50,000	27	9,495,000	2,564,000	5,653,000	1,526,000
$50,000 to $56,000	31	7,047,000	2,185,000	4,187,000	1,297,000
$56,000 to $62,000	35	6,573,000	2,301,000	3,886,000	1,360,000
$62,000 to $68,000	39	5,634,000	2,197,000	3,348,000	1,305,000
$68,000 to $74,000	43	4,347,000	1,869,000	2,583,000	1,111,000
$74,000 to $80,000	47	3,701,000	1,739,000	2,202,000	1,035,000
$80,000 to $90,000	51	4,652,000	2,372,000	2,766,000	1,410,000
$90,000 to $100,000	55	3,628,000	2,000,000	2,138,000	1,176,000
$100,000 to $150,000	58	14,191,000	8,231,000	8,438,000	4,894,000
$150,000 to $200,000	60	4,136,000	2,482,000	2,459,000	1,475,000
$200,000 to $250,000	62	2,814,000	1,745,000	1,674,000	1,038,000
$250,000 to $300,000	64	1,697,000	1,086,000	1,009,000	646,000
$300,000 to $400,000	66	2,522,000	1,665,000	1,664,000	1,098,000
$400,000 to $500,000	68	1,345,000	915,000	799,000	543,000
$500,000 to $750,000	70	938,000	656,000	558,000	391,000
$750,000 to $1,000,000	72	156,000	112,000	92,000	66,000
$1,000,000 to $1,500,000	73	70,000	51,000	6,000	4,000
		$37,870,000	63,559,000	200,603,000	37,637,000
Normal tax			13,496,000		8,024,000
Total			77,055,000		45,661,000

TABLE XXX.—*Distribution of State and Federal interest, respectively, on the basis of corporate bond investments in estates, and estimated taxes thereon*

Net income brackets	Ratio of total corporate bonds in each bracket	Relative distribution of imputed State interest	Median surtax rates	Estimated tax on imputed State interest	Relative distribution of imputed Federal interest	Estimated tax on imputed Federal interest
	Percent		*Percent*			
$5,000 to $10,000	26.67	$89,084,000	6	$5,399,000	$53,500,000	$3,210,000
$10,000 to $25,000	26.71	90,119,000	11	9,913,000	53,580,000	5,894,000
$25,000 to $50,000	18.72	63,161,000	21	13,264,000	37,552,000	7,886,000
$50,000 to $100,000	12.59	42,478,000	45	19,115,000	25,266,000	11,365,000
$100,000 to $150,000	5.22	17,612,000	58	10,215,000	10,471,000	6,073,000
$150,000 to $300,000	4.57	15,419,000	62	9,560,000	9,167,000	5,683,000
$300,000	5.52	18,624,000	70	13,037,000	11,073,000	7,751,000
		337,400,000		80,503,000	200,600,000	47,862,000
Normal tax				13,496,000		8,024,000
Total tax				93,999,000		55,886,000

APPENDIX H

Comments on a statement by Mr. John W. Hanes, Under Secretary of the Treasury, submitted to the Special Committee of the Senate on Taxation of Governmental Securities and Salaries, on January 18, 1939.[16]

The arguments which Mr. Hanes advanced in his statement were based on the paper by Mr. Murphy, cited below. The comments offered here will be prefaced by quoting certain conclusions that were stated by Mr. Murphy as follows:

"First, that the governmental units in the United States issuing tax-exempt securities suffer thereby a much larger loss in revenue than they gain in interest; and, second, that many of the holders of tax-exempt securities suffer an important loss in yield as a result of the tax-exemption privilege, which loss they are able to recoup only partially, or not at all, through savings of taxes. The net balance of loss suffered by both of these classes goes to the benefit of a relatively small class of wealthy individual holders of such securities, who reap benefits from the tax-exemption privilege out of all proportion to the interest yield which they have sacrificed in order to obtain it."

The paper under review here deals with the fiscal effects, but the following is said about the nonfiscal effects:

"The most important nonfiscal effect of the issuance of tax-exempt securities is the diversion of funds which would otherwise be ideally eligible for use as 'enterprise' capital to use as senior capital of the most conservative sort, leaving the need for enterprise capital to be supplied by persons who can ill afford to bear the risk, or, worse yet, leaving the need unmet altogether with resultant unemployment of senior capital and industrial stagnation."

This is a repetition of the argument earlier advanced by Mr. Philip Wenchel, Chief Counsel of the Bureau of Internal Revenue, discussed at pages 153–156, supra. Further comments are unnecessary here.

The first conclusion, which is that the governmental units suffer a much larger loss in revenue than they gain through savings in interest, is supported by the following argument:

Investors may be assumed to take one or other of two possible attitudes in buying tax-exempt securities: (1) They may be assumed to buy them on a purely rational basis, having in mind only the actual relative investment advantage; or (2) they may be assumed to buy such securities through a mixture of motives, rational and irrational, in which case the actual importance of the tax-exemption feature would not be controlling for all purchasers under all circumstances.

Under the first of these cases, Mr. Murphy finds that the small investor becomes the marginal buyer and that he determines the price and yield basis of the exempt securities. This finding supports a contention advanced earlier in the Department of Justice White Book.[17] Mr. Murphy concludes that under the conditions

[16] Mr. Hanes' statement was based on a paper by Henry C. Murphy, of the Treasury Department, before the American Statistical Association, at Detroit, Mich., on December 29, 1938.

[17] Discussed supra, pp. 165–166.

laid down, the revenue loss will be much larger than the interest saving. His illustration and argument may be summarized as follows:

(1) Assume that a country has a flat income-tax rate of 25 percent, and that under this tax, a 4-percent taxable security will sell at par. Then the Government can sell a 3 percent tax-exempt security at par. Whether it issues taxable or exempt securities is a matter of indifference, for the interest saving will balance the revenue loss. Considering administration costs, possible evasion and collection losses, there could be some advantage in the tax exemption.

(2) Mr. Murphy next introduces the following further assumptions:

(*a*) The income-tax rates are graduated, being 10 percent on certain incomes and 25 percent on other incomes.

(*b*) More bonds are to be issued than "can conveniently be absorbed by persons subject to the 25 percent tax."

(*c*) The additional bonds must therefore be sold to persons subject only to the 10-percent tax.

(*d*) Under these conditions, the yield differential between taxable and exempt bonds will drop from 1 percent to 0.4 percent, since persons subject to only a 10-percent income tax will not buy tax-free bonds on a yield basis below 3.6 percent, when they can get this net yield, after taxes, from a 4-percent taxable security. The resulting situation is thus described by Mr. Murphy:

"Individuals subject to the 10-percent tax will then constitute the marginal purchasers of tax-exempt bonds and will determine the price—in this case, of course, the yield—for the whole amount of such bonds."

"Investors subject to the 25-percent tax will now be able to secure tax-free bonds to yield 3.6 percent instead of only 3 percent as previously, and this enhanced yield will represent a net loss to the Government—which will have saved only 0.4 percent in interest cost by making the bonds tax exempt, while it will have lost an amount in revenue equal to a full 1 percent in interest cost."

Comments.—The first comment is that this argument proves that the small investor is the marginal investor by assuming that he is the marginal investor. Since it is assumed that the additional bonds cannot be sold to any persons except those in the 10-percent tax group, naturally it follows that their investment attitude toward them will determine the price and yield basis.

There is some confusion, also, in the final paragraph quoted above, regarding the relative revenue loss and interest gain. The conditions intended by the author are not clearly set out, but a concrete illustration may aid in following the thought. It will also aid in exposing the fallacy. This illustration is as follows:

(1) Suppose that the above country has issued one billion of debt, tax exempt, at 3 percent interest, and that all of this debt is held by persons subject to a 25-percent income tax. Then, on the conditions laid down, the revenue loss, as against an issue of one billion of taxable debt at 4 percent, would be $10,000,000, and the saving in interest would be the same amount.

(2) Suppose, next, that this country introduces income tax rates of 10 percent and 25 percent, and that it then proceeds to borrow another billion from its citizens. By assumption, this second billion must be sold to the 10-percent income tax group, since it cannot "conveniently be absorbed by the persons subject to the 25-percent income tax." The 10-percent tax group of investors will not buy the new bonds, even with tax exemption, on less than a 3.6-percent basis, which means an interest rate of 3.6 percent if the bonds are to be taken at par.

This new rate is said to establish the price and yield basis for the whole amount of Government bonds; that is, for the entire 2 billions. At this point the writers becomes confused by the difference between market yield basis, and interest cost to the Government. Mr. Murphy says that the 25-percent tax group will be able to secure tax-free bonds to yield 3.6 percent instead of only 3 percent as previously, and that this enhanced yield will represent a loss to the Government, which is saving only 0.4 percent in interest while it loses revenue equal to a full 1 percent in interest.

But we are not told how the 25-percent tax group is able to acquire any of the 3.6-percent bonds. The assumption on which the whole argument rests is that this group already holds all of the Government bonds that it can conveniently absorb, which was the reason for offering a higher interest rate to the lower income group when the second loan was made. Now it suddenly appears that the persons in the high-income group can loosen up and buy more bonds, and that they can get them on a 3.6-percent basis. It should be clear that the whole chain of Mr. Murphy's logic has been completely broken by introducing the idea that the 25-percent tax group can, at a later time, acquire more bonds than they held at the time when the Government was obliged to increase the interest rate so as to appeal to the low-income group. The only reason for this increased interest rate was

that the second bond issue could not conveniently be absorbed by the high-income group. If these high income persons really can buy more, there is no reason to suppose that the interest rate must rise to 3.6 percent.

To be sure, the concurrent existence in the market of 3 percent and 3.6 percent bonds, alike in all respects, including the tax exemption, would mean that one issue would go to a premium or the other to a discount, in the process of equalizing yield bases. If the 25-percent tax group were really able to buy more, the 3.6-percent issue would go to a premium, for bonds with that coupon rate would be worth more to persons subject to a 25-percent income tax than to those subject only to a 10-percent tax. But by the original hypothesis, the high-income group cannot buy more than they held at the time of issuing the additional bonds, hence it is to be inferred that the 3 percent's go to a discount sufficient to produce a yield basis of 3.6 percent. After that market adjustment, with its accompanying write-off in investor portfolios, the 25-percent tax group is realizing 3.6 percent on its holdings of Governments, computed on the new market price. Persons in the 25-percent tax group could then sell 3 percent's and buy 3.6 percent's, but the operation would be no more profitable to them than to take in each other's washing. But none of these changes in the market price and yield of the 3 percent's would affect the Government's revenue loss or interest saving, although Mr. Murphy thinks that it would. His error will be clear from the following summary of revenue losses and interest savings:

(a) On the first billion of tax-exempt 3 percent's, the revenue loss is still balanced by the interest gain, notwithstanding that these bonds could be bought at some later time, by anyone who had the money, on a 3.6-percent yield basis.

(b) On the second billion of tax-exempt 3.6 percent's, the interest saving is $4,000,000 (as against the cost of a 4-percent taxable bond), and the revenue loss is $4,000,000 (being 10 percent of the $40,000,000 that would have been paid as interest on a 4-percent taxable issue of $1,000,000,000). In saying that the Government's revenue loss would be equal to a full 1 percent in interest cost, while its interest saving would be measured by only 0.4 percent, Mr. Murphy evidently forgot that the 10-percent tax group would pay income tax at 10 percent and not at 25 percent. He evidently forgot also his major assumption, which was that the amount of bonds that could be absorbed by the high-income group was strictly limited. And finally, he forgot that the terms of revenue loss and interest-saving on the first installment, the debt were established at the time of issue, and hence could not be affected by subsequent changes of yield basis.

Notwithstanding all of these changes in the assumptions and gaps in the logic, Mr. Murphy proceeds to generalize as follows:

"* * * whenever tax-exempt securities exist simultaneously with progressive income taxes and investors act rationally, the interest saving to the Government arising from the issuance of the tax-exempt securities will be measured only by the value of the tax exemption to the marginal holders of the bonds—that is, the investors in the lowest tax bracket by whom bonds must be held in order to absorb the entire supply. The revenue loss to the Government, however, arising from the issuance of the tax-exempt securities, will be measured by the total tax savings to all investors bracket-by-bracket, and hence must be greater than the corresponding interest saving."

Comment.—In its generalized form the argument and conclusion are equally defective, for the proof that the price and yield of a tax-exempt security are established by those investors to whom the exemption, as such, is worth little or nothing rests on the assumption that the ability of those in the high-income brackets to acquire more of the bonds is definitely limited. Discard this assumption, as Mr. Murphy evidently does in reaching his conclusion, and the whole question of price and yield, of interest saving versus revenue loss, becomes an open one. Certainly the small income investor disappears from the scene as the marginal investor, so strategically located and motivated as to become the regulator of price and yield.

The unreality of the kind of analysis that has been reviewed to this point is clear enough. Mr. Murphy abandons it, by turning to another series of assumptions, stated thus:

"* * * let us assume that many investors insist upon purchasing, or find it necessary to purchase, Government securities irrespective of nice calculations based upon the yield obtainable from taxable bonds of equal safety and the value of the tax-exemption privilege to them."

Under this condition, which corresponds more closely with actual market circumstances than the hypothesis advanced earlier, and under which nothing is said about the limited ability of any income group to absorb tax-exempt bonds, Mr. Murphy finds that "the persons to whom the tax-exemption privilege is of

considerable value may become the marginal bidders for many types of Government securities—".

From this point the emphasis in Mr. Murphy's paper changes, and the injurious effects of an abnormally low Government interest rate on many classes of investors is stressed. This is the second point brought out in the general summary of conclusions quoted on page 181 above, to the effect that "many holders of tax-exempt securities suffer an important loss in yield, which loss they are able to recoup only partially, or not at all, through savings in taxes." Thus, the beneficiaries of public trust funds are said to be injured by the low yield on the tax-exempt securities held in these funds. Mutual savings banks, building associations, insurance companies, and many commercial banks, are said to be investing, or trying to invest, the funds of others who are mainly persons with small incomes. If the exemption privilege were eliminated, the revenue which these institutions receive from government bonds would be increased, except as the income tax exemption which some of these groups now enjoy might later be removed. A plea is also made for the small investor, who ought to get a larger interest return on his investment in Government securities.

The magnitude of the gains which all of these classes of investors would be expected to enjoy, after the removal of tax exemption, is suggested by the statement, quoted above, that many of them now suffer an important loss in yield. This clearly implies that the interest rate on tax exempt securities has been abnormally depressed and that the removal of the exemption would produce a sufficient rise of interest rates on public securities to restore this important loss of yield. But in a later section of the paper, as will be seen, the effects of removing the tax exemption on interest rates and interest costs are minimized and made to appear of little importance. This is part of the general effort to show that interest savings will be far less than revenue losses. Just how an important loss of yield to investors can be made good without incurring an important increase of interest costs to the debtor governments is nowhere considered.

Furthermore, it is hinted that such gains as various institutions might temporarily enjoy from a rise of interest rates following the elimination of tax exemption will last only until these gains are cut into by Federal or local taxes. It is most unlikely that the States will ever tax their own pension funds, but some Federal departments believe that a Federal right to tax these State trust funds already exists.[18] The third stage of the general conclusion quoted on page 181 above is that the net balance of the alleged revenue loss to government and of the investment loss to certain investors goes to the benefit of a few wealthy individual holders of such securities.

This viewpoint has already been discussed at length in the foregoing report. With respect to State and local securities, it is clear that whatever increase of interest costs may be produced by the elimination of their immunity from Federal taxation will fall upon the taxpayers who must support State and local government. This group is not mentioned in Mr. Murphy's paper, nor is the effect of the proposed tax changes upon it a matter about which any concern is expressed. As the language that is quoted on page 181 indicates, the subject is treated as if the only matter involved were the recovery from a few individuals of the benefits now derived by them from tax exemption. Were it possible to effect such recovery without producing equal or even more severe adverse effects in other directions, there would be no objection to the move from a fiscal standpoint, although the case for doing it in an orderly and definite manner by constitutional action would be as strong as ever.

However the action against the few wealthy individuals be taken, it is impossible to penalize them without also penalizing many millions of small taxpayers throughout the nation. The problem is not as narrow and one-sided as Mr. Murphy, together with many others, has assumed; it is a complicated problem which involves careful balancing of gains and losses in various directions.

Finally, the statement under review deals briefly with the effect of the removal of tax exemption on Government interest rates. The approach here is that of showing the relative unimportance of the tax-exemption privilege as a factor in market valuation, and hence of showing that the elimination of exemption privileges will cause but little readjustment in interest rates. Even so, Mr. Murphy concedes that the interest rate on long-term debt will be increased by one-fourth to one-half percent. He estimates the value of partial exemption to individuals at one-eighth percent, but does not consider the fact that all Federal bonds and notes are completely exempt when held by corporations. However, on the basis

[18] Supra, p. 115.

of these estimates of the effect of the removal of tax exemption, the additional interest cost to the Federal Government on the debt volume as of June 30, 1937, produced by eliminating the exemption of Federal interest from Federal income tax, would be from $90,000,000 to $110,000,000 annually. This calculation is made by assuming one-eighth percent increase for the partially exempt debt, and an average increase of three-eighths percent for the wholly exempt debt, which produces a total increase of $90,000,000; or an increase of one-half percent on the long-term debt, which would produce the total of $110,000,000. In other words, from the purely fiscal standpoint, the Federal Government starts with a handicap of not less than $90,000,000 to $110,000,000 in increased interest cost, and the net advantage to the Treasury will consist only in the amount of revenue to be realized above such figures.

Mr. Hanes, in his statement before the special Senate committee, accepted Mr. Murphy's suggestions as to the effect of Federal interest rates, but he offered an estimate of total increased interest cost of from $19,000,000 to $50,000,000. There is a very definite and obvious discrepancy between the conceded effects on interest rates and the resulting effects on total interest cost.

The calculations of Federal interest cost in this report have assumed 20 points increase for the short-term debt, except for the bills and certificates, and 50 points for the long-term debt. These ratios of increase are in substantial agreement with the one-fourth to one-half percent suggested by Mr. Hanes. It is assumed, in this report, that the partially exempt bonds will react to the removal of exemption in a greater degree than is conceded by Mr. Hanes, because of the fact that they are now wholly exempt when held by corporations of every description.

It seems proper to suggest that the Treasury has available certain data which, if properly utilized, might go far toward settling the argument about the classes of investors who establish the interest rates on the Federal debt. These data consist, first, of the factors that are considered by Treasury officials in deciding upon the terms of a bond or note issue, and second, of the subscriptions which are made to the successive offerings. If careful minutes had been kept of the various staff conferences which precede the announcement of each offering, it should be possible to ascertain the extent to which the terms of issue had been fixed with reference to the attitude of the various classes of potential subscribers. It would be possible to discover if these conferences gave any weight to the attitude of those persons with small incomes, who are supposed by many to be the marginal buyers and whose attitude is supposed effectively to determine the interest terms of the issue. From an analysis and classification of the subscriptions and allotments, it would be possible to show who are the original purchasers of the successive issues, and with this information it would be possible to arrive at some fairly definite inferences as to the motives which appeared to govern them in making these subscriptions. With such information it would be possible to estimate more accurately the probable effects of the removal of tax exemption.

Another, and even better suggestion, was offered by Dr. C. O. Hardy in the discussion of the papers given at the meeting of the American Statistical Association in Detroit on December 29, 1938. This was that in forthcoming bond issues, the offering be divided, part being wholly exempt, part only partially exempt, and part having no exemption privilege. This would provide a perfect comparison, as the only difference in the attractiveness of the bonds would be the difference in taxable status. Any market differentials that were established would supply a fairly definite clue to the current appraisal of the tax-exemption privilege.

Messrs. Hanes and Murphy alike reveal a certain confusion in their discussion of the way in which the price and yield bases of the tax-exempt bonds are determined. For illustration some passages in Mr. Hanes' statement are used.

In one place Mr. Hanes says:

"The reason for the small differential in interest rates, despite the high preferential value of the tax exemption privilege is that the interest saving arising from the issuance of tax-exempt securities is measured only by the value of tax-exemption to those bondholders who fall in the lowest tax brackets."

This statement obviously rests on the kind of reasoning advanced by Mr. Murphy, and dealt with in the early part of this memorandum. The fallacy as to the amount of interest saving which results from proving that the small investor is the marginal buyer by assuming that he is the marginal buyer has been pointed out above. Yet, here the small investor is made the controlling influence in establishing the yield basis.

But in another place, two pages farther on, Mr. Hanes says:

"Persons with large incomes derive much greater benefits in reduced taxes than they pay for through sacrifice of interest returns. Part of this excess benefit

falls as a burden on holders of tax-exempt securities who need them for other reasons but *must pay the same premiums as do the individuals in the higher income brackets.*" [Italics ours.]

Here it is evident that the individuals in the high-income brackets are regarded as the principal factor in establishing the price and yield basis, and all others who want public securities must meet the terms which such individuals establish.

This inconsistency of saying that the marginal buyer is the small investor, and then that he is the large investor is so obvious and so extraordinary that no comment is needed.

The sentences of Mr. Hanes' statement which follow immediately after the second passage quoted above indicate a certain wishful thinking. These sentences are:

"The remaining excess benefit must be paid by the general taxpayer who is called upon to make up the deficit in revenue. Neither of the burdened groups (i. e., those who accept an abnormally low return and the general taxpayers) is as able to bear the additional load as are the individuals in the higher income brackets who receive the benefits."

This statement implies that the individuals in the high-income brackets will continue to hold just as many of the public securities after the removal of tax exemption as they now hold. The conclusions arrived at elsewhere by Messrs. Hanes and Murphy indicate a belief that they will also hold them at a price and yield basis very little above the present levels, for both of these writers minimize the increase of interest costs while stressing greatly the prospective revenue yields.

But what assurance is there that these bonds will stay in the portfolios of those in the high-income brackets once the exemption is removed? It is strongly implied by both writers that these persons attach a higher importance to the exemption than to other features. When that particular feature is removed, they would have little or no reason for carrying them longer. Hence the suggestion that they could be made to carry an additional tax load, through removal of the exemption, is a hope rather than a certainty.

If the public securities should be generally dislodged from the high-income brackets by the removal of tax exemption, where will they go and what will be the fiscal results of this shift? Naturally, they must pass into possession of those to whom the other features of a public security are supposed to be of more importance than tax exemption. Unless these groups have an indefinite capacity to absorb the securities at only such slight advance over the current interest rates as is predicted by Messrs. Hanes and Murphy, additional inducement must be provided in higher rates. Insofar as these interest rates rise, the burden on other taxpayers is increased, while at the same time the prospective revenues will diminish, for the groups that are supposed to be least concerned with tax exemption as such are the small investors, the exempt institutions, and the corporations likely to have little or no net income anyway. Little or no income tax is collected from these groups. Neither Mr. Hanes nor Mr. Murphy has given any attention to the balance of gains and losses under such a condition as this, although its emergence is to be strongly inferred from the line of analysis which they have followed.

Should the interest rates rise to a level that would again attract those with substantial incomes, the revenue will rise, but the interest costs will also have risen in the meantime.

The CHAIRMAN. Dr. Lutz, we are glad to have you here.

STATEMENT OF DR. HARLEY L. LUTZ, PROFESSOR OF PUBLIC FINANCE, PRINCETON UNIVERSITY, PRINCETON, N. J.

Dr. LUTZ. Mr. Chairman and gentlemen of the committee: The report which Mr. Tremaine has handed you as coming from me is in two main sections, as you will observe; one, an examination of the physical results of various possibilities of dealing with the taxation of public securities, and the other, an examination of some of the general governmental and social aspects of that probability.

The CHAIRMAN. As I understand it, you do not attempt to cover the legal phases in this report?

Dr. LUTZ. No, sir; not at all. In the first part of my report, dealing with the physical results, I have approached it from various points

of view—various possibilities in dealing with questions of public securities, and I have called them, for convenience, various options.

Option 1 is the first and simplest case, in which the Federal Government taxes the interest of State and local securities, with no thought of reciprocity of State taxing of Federal interest.

The second option is one in which there is complete reciprocity.

The third option is one which relates to the Federal Government alone. Federal taxation of Federal interest. It is obvious that is something that can be dealt with either by itself or in combination with the other possible requirements and constitutional action.

There is no controversy between the Federal Government and the State in this connection, and, therefore, it is something that can be dealt with at any time that the Congress sees fit.

Options 1 and 2: As a matter of fact, the subject falls into two parts, because the whole question of Federal relationship may be involved as to the way to proceed, while the third option involves none, and, as a matter of fact, the whole question of reciprocity has dealt simply with this matter of State and Federal taxation. The amendment of 1922 did not couple with it Federal taxation of Federal interest. It is a question of whether there was any intention to couple with a proposed amendment today Federal taxation of Federal interest.

Now, if we do not include in an amendment, assuming we are coming to that stage, a requirement that the Federal Government tax its own interest as a condition of taxing State interest, obviously there will be no taxation of Federal interest except at the discretion of the Congress, and, whether the present Congress should do it or not, a future Congress could cover taxation of Federal interest as well.

If we should make it obligatory that the Federal Government tax its own interest as well as the State interest, then, in any future Congress, we are going to be in a very serious difficulty with respect to Federal interest because of that restriction of its policy.

Now, let us turn to a consideration of these various options, and I will outline very briefly the results I have obtained. They are shown on this chart on the wall. Small reproductions of the same chart, I believe, are in your hands.

The CHAIRMAN. I have one, but I do not think that Senator Byrd has one.

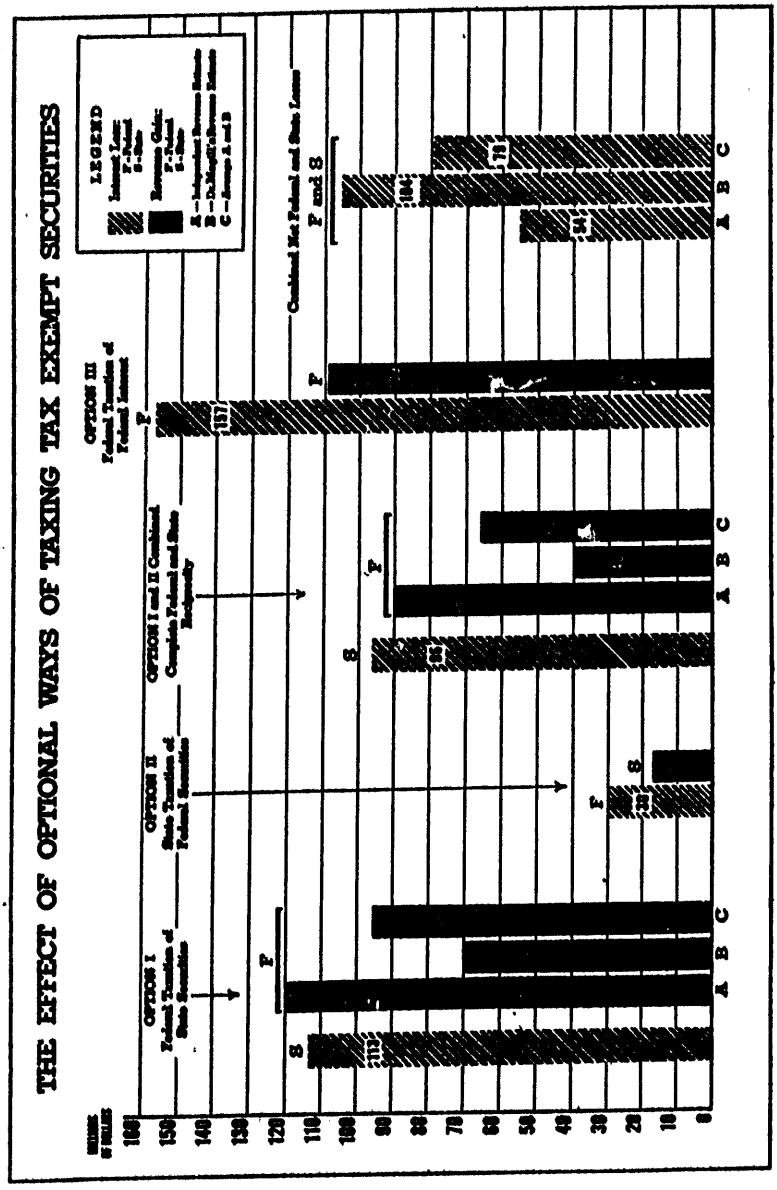
(The chart shown on p. 188 was placed before the members of the committee.)

Dr. LUTZ. Now, the first option, which is simply the Federal taxation of State and local interest with no reciprocity. Obviously, the State would get no revenue, so it becomes a tax with only Federal revenue receipts.

I think it would not be relevant, Mr. Chairman, for me to go at any length into the methods I have used in arriving at these results, but I should like to show, with respect first of all as to the cost to the State, that I have approached that from the standpoint of the probable effect upon State interest payments that would be produced by the present scheme of Federal tax rates upon the holders of State and local securities.

Now, the chief problem is to decide how much of effect will be produced by these taxes. Naturally, we had to proceed from the standpoint of opinion and inference, to a considerable extent, because,

so far, there have been no State securities subject to Federal tax, and, therefore, we have no positive evidence. The report outlines various kinds of opinion evidence that we secured by a canvass of investment houses dealing in State and local securities, a canvass of



the large insurance companies and examination of the actual market situation—market spending—and also what you might call a deductive approach; that is, what would happen on the assumption the investors sought to shift the tax.

Out of all these approaches, I came to this result, which I adopted for the purpose of computation: That the effect of the present scheme of Federal taxation would produce something like three-fifths of 1 percent, or 60 on the long-term debt, and something like one-fifth in the cost of the short-term State and local debt.

Now, applying those figures to the present volume of State and local debt, on the assumption that we are seeking the burden at a time when the taxable State and local debt is equal to the present folume of immune debt outstanding, we come to the result it will cost the States and cities something like $113,000,000.

Senator LOGAN. You mean, if, in the future, the States and municipalities should cause to be issued bonds equal to the amount that are now outstanding?

Dr. LUTZ. Yes; that is right.

Senator TOWNSEND. That is not likely, is it?

Dr. LUTZ. Senator, I would not want to predict, and I do not mean to imply any positive prediction in regard to the volume of either State or Federal debt. Your question would imply, if I answer it as you have suggested, that at some time the States and cities will be out of debt. I do not mean to say anything with respect to whether they are going to be out of debt or that they will have a greater or less debt than at the present time.

The only way in which one can seek answers to these important questions that come up is to consider what would be the effect of, and as the result of, refunding, or as the result of obligations to meet new requirements, we should find, in 14 to 20, or 30, or 40 years, with State and local indebtedness of 19,300,000,000, which had been issued, either of refunding or new issue since the tax went into effect.

Now, what, under those circumstances, would be the additional State cost to the debtor government as the result of a tax program such as we now have in operation, and the answer to that I believe to be something like 113,000,000, on the assumption that the average mark-up, as the result of taxes, would be something like three-fifths of 1 percent in the long-term debt.

Of course, if there was more than that, naturally, that cost would be greater.

Now, against that, we have the question of how much revenue the Federal Government might expect to obtain from the taxation of that interest. That is a very difficult question to answer, and I claim for my answer to it only that reasonable probability that one can claim for anything that has been arrived at on the basis of such evidence as we can get. What is that evidence?

In the first place, we must find out where the bonds are. I find that the distribution of the State and local securities which is reported by the Treasury Department in its recent publication of distribution and ownership of tax-exempt securities has been of extremely great value. In fact, it would have been difficult to make such a study as this without that particular compilation.

We must set aside those that are in the hands of tax-exempt institutions, such as universities, mutual savings banks, and so on, and I was obliged to take this procedure.

The CHAIRMAN. Did you say in cases of mutual savings banks?

Dr. LUTZ. Yes, sir.

The CHAIRMAN. Do you think they would be exempt, Doctor?

Dr. LUTZ. I understand that they are exempted by the statute.

The CHAIRMAN. By the State law?

Dr. LUTZ. No. I mean from the Federal income tax, wherein fraternal societies, and so on, are exempted. When in fact, we make that distribution on this class of holders, the quantity figures were the only figures. Then we had to allocate to individuals of net income of $5,000 everything you could not place anywhere else. Obviously, that is where the bulk of the tax is going to be.

Consequently, if I have allocated too many of these bonds to the high income, my revenue, of course, will be more inflated. But, to come to the net of it: As the result of the conclusions which are already set out in the total of the report, I come to a figure of something like 120,000,000, as probable revenue which the Federal Government would receive.

Senator LOGAN. I must confess that I am a little confused on that. As I understand it, the Treasury officials indicate the Federal revenue would be almost inconsequential. That is my recollection.

Dr. LUTZ. From State and local securities.

The CHAIRMAN. I think what was meant by that was the earlier years, but not later on.

Senator LOGAN. That is true, but I would assume that no one is going to think that the Federal Government is going to increase its indebtedness much more.

Dr. LUTZ. Pardon me. I am speaking of the volume of State and local debt and revenue the Federal Government might hope to obtain eventually from taxing that interest.

Senator LOGAN. But, as I understand, before it would receive the revenue indicated in your chart, the new issues would have to aggregate what the outstanding obligations are at the present time.

Dr. LUTZ. That is right. You see, there is no way of saying what the revenue would be under any other circumstances except those we how have before us.

Senator LOGAN. Do you think that we will ever get that far—to have as much outstanding indebtedness, of State, national, and municipal indebtedness, as we have now—without the country being destroyed?

Dr. LUTZ. If you will pardon me, I should say that what we have to consider is that time when the present indebtedness will have been transformed into a taxable indebtedness, either by refund or partially by redemption, and the issue of a new debt for new purposes or for continuance of the old functions after the change of tax statutes has gone into effect.

Senator LOGAN. You are assuming that, if refunding bonds in place of those outstanding should be issued, the new issue would be subject to taxation. I had a different idea about that. I thought they would be exempt, the same as the original issue.

Dr. LUTZ. Pardon me. That is a point which I have dealt with in the report, and I have raised the question whether the refunding bond is to carry all the virtues of the original issue or not, and I have, for the purpose of my calculation, assumed that the refunding bonds will not carry this particular attribute of tax exemption.

Senator LOGAN. You are talking upon the assumption that there will have to be a constitutional amendment before any of this can be done?

Dr. LUTZ. No, sir; I am not saying anything here about the way of doing it, but I am merely talking about what will happen when done by statute or constitutional amendment, as the case may be.

Senator LOGAN. Thank you.

Dr. LUTZ. Now, I come to the $120,000,000 revenue that the Federal Government would receive after the item of $19,000,000,000 at such rates of interest as would be paid would become taxable, which is indicated by the first black column under "F," which means the Federal side of the case. At that point I observed that Dr. Roswell Magill, in an address before the National Tax Association at Baltimore, in 1937, made the statement that, according to the best information they had available in the Treasury Department, they could not show, or did not feel justified in estimating, more than $70,000,000 to Federal revenue on the outstanding amount of State and local bond issues at the present rate of taxation.

Now, you can imagine that statement rather stumped me, for here was a high Treasury official who comes out with a figure a little more than half of what we arrived at there. The only thing that I can say in reply to that is to put my figure—a layman's figure—against the official Treasury estimate, and let the reader take his choice as to the comparative accuracy of the two.

In the second black column is Dr. Magill's estimate of $70,000,000, and then, for your information, I put down the average of the two as the third black column. So that we have three possible results of the Federal taxation of State and local interest: My figure of $120,000,000, Dr. Magill's figure of $70,000,000, and an average of $95,000,000; and it is a guess as to who is the nearest to the truth.

The CHAIRMAN. You have heretofore stated the factors which cause the difference in the estimate. As I gather from your statement, some of these bonds are in the hands of institutions that are tax exempt, and, of course, there is no way you can now tell us what part of the bonds are held by people whose incomes are in the lower brackets and by those whose incomes are in the higher brackets; and those are factors that make it difficult to give an accurate answer.

Dr. LUTZ. Yes.

The CHAIRMAN. That accounts for the great difference, then, between your estimate and Dr. Magill's estimate?

Dr. LUTZ. I am not sure that is the real explanation, because I gave full allowance, so far as I could, on the basis of the Treasury records on distribution of ownership of the bonds in trust funds, the bonds that were held by exempted institutions, and those that might be held by individuals with small incomes.

Senator LOGAN. Then, what other factors do you say exist that explain the great difference between the two?

Dr. LUTZ. I cannot give you an answer on that. I was puzzled at the time I was reading the report to understand why Dr. Magill arrived at such a different figure, and, for that very reason, I thought that I should put into the report these two divergent results, and then the reader can take his choice.

Now, you see, therefore, that on this basis, even on the most optimistic approach to it, the Federal Government would not receive very much more than the States would have to pay out.

Senator TOWNSEND. It does not receive as much?

Dr. LUTZ. I have $120,000,000, as against $113,000,000.

Senator BYRD. How much would the States receive, if any?

Dr. LUTZ. We are coming to that in the very next stage, which I call chart 2. That is the second possibility—the possibility of States taxing Federal interest as well as the Federal taxing of State interest.

So, if we bring that next stage into the argument, we have the question of what the States would receive if they tax the Federal interest.

The CHAIRMAN. I take it from Mr. Tremaine's statement that he estimated that the additional cost in interest to the States and municipalities would be three-fourths of 1 percent. Now, you fix that, do you, at 60 percent, except you made a statement regarding short-term securities?

Dr. LUTZ. Yes.

The CHAIRMAN. Well, could you get it down to a factor, as Mr. Tremaine has it; an average of the two? Am I reasonably safe in saying 60 percent is the general average of increase?

Dr. LUTZ. Of course; I have not discussed this point with Mr. Tremaine. I did not know that he was talking about short-term bonds, the kind of thing you are doing when you issue tax anticipation notes which will be taken up in a few years. That is what I mean when I speak of short-term borrowing, and, against that, the 10-, 20-, or 30-year bonds that are issued in long-term borrowing. So, I am not certain that Mr. Tremaine meant his figure of three-fourths of 1 percent to apply to the short term as well as the long term.

The CHAIRMAN. My idea is this: I want to carry in my mind a figure of estimate as the additional cost.

Dr. LUTZ. Let us call it 60 points, or three-fifths percent, because, as a matter of fact, the amount of short-term borrowing is comparatively a small proportion of the total debt.

The CHAIRMAN. In your legend here, you call your shaded column, "Interest lost." Now, I am assuming—and my mind seems to run the other way—that that is additional interest cost.

Dr. LUTZ. Yes; as we have called the other "Revenue gain," and "Interest lost," additional interest cost.

The CHAIRMAN. I think I understand it now. Now, we are down to option 2.

Dr. LUTZ. When we come to option 2, we have the same procedure of analysis, to discover how much the States might get from taxation of Federal interest; how much that would affect the cost of the borrowing to the Federal Government.

The problem was even more difficult there, because no two of the States which have income taxes have the same schedule of rates. So, after looking over the various State tax schedules, with respect both to individuals and corporations, I decided to base the computation on a typical maximum rate of 5 percent for the individual and 4 percent for the corporations.

There are some States where it runs higher, and then there are some States that do not run quite so high.

Then, after the same procedure of allocating interest of the Federal Government to these immune and exempt agencies, and making some assumption as to its distribution, I came out with the result that, under the conditions obtaining in 1937, the States might have expected to receive something like $16,000,000 in revenue, if they had been free to tax the Federal interest paid in that year. That is the black column under option 2.

If the Federal interest paid in 1937 had been exposed to State income taxation, I calculated that it would have resulted in an interest-rate adjustment that would result in a cost to the Federal Government of something like $30,000,000.

Now, if the Senator desires, I will go into that.

Senator BYRD. You mean by that, the States would get $30,000,000 additional?

Dr. LUTZ. No, the Federal Government would have to pay $30,000,000 interest additional.

Senator BYRD. I understood you to say the total cost to the State and Federal Governments would be $113,000,000. Is that correct?

Dr. LUTZ. If the chairman will permit, I will read you the procedure I was following, so you will understand that difference.

The first situation to discuss was this situation, the Federal Government will be taxing the interest on State and local debts, but the States will have no reciprocal privilege of taxing the Federal debt.

Then there is, possibly, the second situation, what I call option 2, which brings into that picture the reciprocal situation of the States taxing Federal interest.

So, as we build up, you start with the simple proposition: Is the Federal Government to tax State interest with no reciprocal considerations? Then, we bring in the reciprocal consideration, with the States taxing the Federal interest, as well as the Federal Government taxing the State interest.

It is on that first situation that I have the figures and additional interest cost to the States, interest of $113,000,000 if the Federal Government taxes State and local interest.

Now, we come to this proposition which enters into this picture: If the State taxes the Federal interest.

The CHAIRMAN. Dr. Lutz, I recognize that you cannot make this study without building it upon present conditions. But, we all know that if this statute is enacted, or if the constitutional amendment is adopted, that it will take a great many years for the full effect of this new plan to be felt.

Dr. LUTZ. That is right.

The CHAIRMAN. Now, I do not want to charge you with being unfair; but, certainly, if this reciprocal arrangement was made, many of these States that do not have income tax law would certainly enact income-tax laws. I think you could look for something of a rise in their revenues, and I think that you are aware of what the practical situation would be in a very short time. Am I right or wrong about that?

Dr. LUTZ. I think you are right to this extent, that, if, as a result of this change by statute or by amendment, all of the States which do not now have income-tax laws would proceed to enact income-tax laws, or all of the 48 States would raise the rate on income tax, then, I think, you are correct. The figures I have set down under option 2 are too low.

I do not want to predict that New Jersey or Illinois are going to have income taxes as a result of this measure.

I point out in the report that one of the reasons why so many of the States do not have income tax now is because there is such strong local sentiment against it, and a very strong prejudice for some of the other taxes. And you know, Mr. Chairman, in your own State of

Michigan, how much pressure would have to be put on the people of Michigan to have an income tax.

My figures, I am frank to say, have to do with the situation as it obtained in 1937.

The CHAIRMAN. I just wanted to recognize that fact.

Dr. LUTZ. I quite agree with you on that, since I do not want to enter into the role of prophet and say when New Jersey or Illinois are going to have income taxes, and bring into the question that they will all add to it.

So, we have, in the third set of borrowings on this chart——

The CHAIRMAN. Before you leave No. 2, my recollection is rather hazy on it. We are paying, I think, pretty close to $1,000,000,000 a year on Federal bonds at the present time.

Dr. LUTZ. I believe the Treasury figure, given as the total interest paid by the Federal Government and the Federal agencies, is $1,148,000,000 in 1937.

The CHAIRMAN. You mean including Home Owners' loans, and other agencies?

Dr. LUTZ. Yes, sir.

The CHAIRMAN. My recollection is it was just under $1,000,000,000 on the securities issued by the Government alone.

Dr. LUTZ. That is my impression.

The CHAIRMAN. You believe that out of that amount only $17,000,000 would reach the State treasuries by way of present State income taxes?

Dr. LUTZ. Yes, sir. Would you want me to review the argument, as set out in the report, as to how it is arrived at?

The CHAIRMAN. I do not think that is necessary.

You feel that $17,000,000 would be approximately the tax that the States would collect on about a billion dollars?

Dr. LUTZ. No, I think we would have to state our position a little more fully. You see, the whole $1,148,000,000 is not going to be exposed to State income taxation.

In the first place, there is that part of it which is paid to the public agencies, and, in the second place, we must set aside a certain amount of the Federal interest which is paid to those exempted institutions which hold Federal securities, and, in the third place, we have my estimate as of 1937 for the amount of Federal interest which was received by corporations, I think $555,000,000, or, in other words, approximately one-half was paid to corporations.

Now, the case of corporations is very interesting, because in some years they make a net income, and are subject to income tax, and in some years they do not.

The CHAIRMAN. It is very difficult to estimate?

Dr. LUTZ. It is. I will tell you what I did on that. I took the 10-year record for corporations having net incomes and corporations having no net income. I found, in a good year, only about a quarter of the corporations would have no net income, and, in a better year, three-quarters—I beg you pardon. I did not state that exactly. I meant, the Federal securities owned by corporations having net incomes, and those corporations having income will fluctuate from 25 percent to 75 percent, and, for the 10-year period, on the average, it is just about even.

The CHAIRMAN. What 10-year period was that?

Dr. LUTZ. It was the last 10 years, covered by statistics from corporations, from 1935 back through 1926, when they began to refer to the holding of tax-exempt securities.

The CHAIRMAN. Of course, we do not know what is going to happen in the future. It has not been so good in the past 10 years.

Dr. LUTZ. Part of it was good, so far as the corporate income was concerned, and part was bad; about a 50–50 basis. So, I concluded that for these corporations you might assume, on the average, 60 percent only of the tax-exempt securities would be held by corporations with net incomes, and, therefore, you have got to reduce the interest still further. When you get all of them, you can appreciate that we are a long way from the over-all interest payment of $1,148,000,000.

So, it was on that basis that my figures showed the cost.

The CHAIRMAN. I want to ask you one more question. I was interested, in scanning through your report, to ascertain what you had found as to the amount of Federal securities in the hands of the Social Security Board.

Dr. LUTZ. Senator, I am sorry I cannot answer that question, for I do not attempt to tell the ownership of these securities by detailed agency any further than their ownership was disclosed by the Treasury memorandum that I referred to.

Since they are all in the same category, as far as my purpose was concerned, it seemed that there was no difference occasioned whether the Federal Reserve held them or the Social Security Board held them.

The CHAIRMAN. Your position is that there could be some tax, from the securities the Federal Government so held, by the States?

Dr. LUTZ. Yes; but I do not quite see which State would have the privilege of imposing such a tax.

The CHAIRMAN. I think you are right about that.

Dr. LUTZ. Now, under the third set of borrowers, if I might proceed, in the shaded adjustment made, bringing over the results of options 1 and 2.

As I said, as the result of the two options, the State loss would be $113,000,000, or an additional million, less the estimated 17 millions of revenue, and the final additional net cost of 96 million, and Federal gains under the various amounts shown under "A," "B," and "C," the estimate of $30,000,000 of additional State cost.

I think the situation of the States and the cities under this arrangement is something that should be touched on just a little bit further, if I may.

We have been speaking of complete reciprocity between the Federal Government and the States, however it may be granted, whether by statute or by constitutional amendment.

We agree that either method furnishes the same situation, but the first thing that comes up is the question of the social-security program.

The Federal Government is proposing to grant to the States the right to tax the interest on its securities, but, as the committee is fully aware, the first arrangement of the social security finally contemplated that, in 30 or 40 years, a large part of the Federal debt may be transferred to the social-security reserves for the old-age fund, and so on.

Of course, if that happens—and it will happen, unless the law is changed—I presume that is the point you were getting at in your question a moment ago.

Then, there is this question of the States that have no State income-tax laws—you might have all of the States that would proceed to enact income-tax laws, and it would increase that materially. But, I have no assurance of that.

I think we might say this. I think there is just this one obstacle in the way, which I think would be possibly discouragement enough, so far as the State acting in that way is concerned, and that is if the Federal Government continues with the present rate.

But, in the case of the city, if the States are to get a certain amount of revenue from this tax, it is not certain that it is going to help the cities, and more than one-half of the local State debts are obligations to the cities.

The CHAIRMAN. In your shaded column, do you include municipalities, drainage districts, and so forth?

Dr. LUTZ. I included all, everything that is in the nature of State and local obligations. That is all put together there. But it is a fact that the States own more than one-half of the present indebtedness of the cities; that is, they own more than one-half of the total indebtedness.

Now, in a few States, of which New York is one, the income tax is a State exaction. New York does share her income tax with the subdivisions, but in most of the States it is a State revenue.

And, you see what we will have. We will have the State collecting the income tax, and the city will have the difficult job of getting additional money out of their budget with which to pay the additional interest cost of municipalities, possibly through districts, and other districts included, under the general city obligations, and you will find in our report an estimate as to the effect on particular cities, and groups of cities, and a calculation that shows in still greater detail as to what would happen in New York and New Jersey after the impost of a Federal tax.

I was extremely interested to find, even in the case of New York State, as to the share of the State income tax which goes, for example, to New York City, today, that the State tax on all incomes is only a little more than what it would cost New York City to carry a share in Federal tax on securities outstanding for New York City, and we know that in other cities of New York State it is even a less favorable comparison.

Now, may I pass on to the third option, which is a Federal situation alone.

Again using the same procedure as to allocation of interest to various classes of holders I have used in the report up to this point, and the same assumptions as to where the interest will be paid, and the tax, we get the Federal revenue of something like $109,000,000.

In the case of the Federal interest cost, I have computed that cost at $157,000,000, on the assumption that the fact of the Federal tax on its own interest would be 50 points under one-half percent, the same thing that Mr. Hanes suggested as a possible proportionate increase with respect to the long-term debt.

I have used a 10 percent, or one-tenth of a percent, in the case of short-term notes which the Treasury issued, and I have assumed it will have no effect on bills and temporary borrowings where there is no interest on that kind of borrowings, and, consequently, the tax on it would produce no particular effect, while that somewhat abnormal situation in the bill market prevails.

Then, finally, in the last kind of borrowing in this chart it brings together the result of all three options, if you put them all together. That is to say, if we combine all of the gains which the States might expect to obtain and set them off against the losses which the State would suffer, we get the final net loss for the State, and final net loss for the Federal Government.

The variation is caused by the fact that I have used my own figures, Dr. Magill's figures, and the average of the two, so that the first and shorter of the shaded bars would be smaller, total net loss on interest cost over revenue gained, if we assumed the Federal revenue from the taxation of Federal securities is $120,000,000. If we only assume $70,000,000, obviously that loss is going to be somewhat greater than it would be under the one if you use an average, the final figure of $70,000,000.

Now, if the committee will bear with me just a moment longer, I should like to mention one or two points in the second part of the report, if there is no question further on these figures.

In the second part of the report, I have attempted to deal with the argument of the general nature for the removal of the so-called tax-exempt people.

The CHAIRMAN. You start on 123 of the report?

Dr. LUTZ. The principal argument on the evil of tax-exempt securities' immunity is that the existence of these securities interfere with progressive income taxation.

In the first place, we must always compute strict progression, and it might be that the taxation of tax-exempt securities is really in line with progression, whether or not it depends on the amount of the income in their hands.

Instead of computing it from the top down, as is usually done, when you start to figure out how much income one must have on taxable securities to equal 3 percent on tax-exempt securities, I have started at the bottom and I worked up. Now, what is the breaking point for the average man? If he invests various amounts in exempt bonds, obviously, if he is down in the income scale, he loses money by that process, for he will have more money in his pocket by owning taxable securities than if he had tax-exempt securities.

The CHAIRMAN. I want to go back for a moment, Dr. Lutz. Take the conclusion you reach over on the right of the chart. You estimate an annual loss under "A" of $54,000,000, under "B" of $104,000,000, and under "C" of $79,000,000?

Dr. LUTZ. That is right.

The CHAIRMAN. "A" is your own estimate?

Dr. LUTZ. That is the loss based on my estimate.

The CHAIRMAN. And "B" is Dr. Magill's estimate?

Dr. LUTZ. Yes.

The CHAIRMAN. "C" is the average?

Dr. LUTZ. That is right.

The CHAIRMAN. Does that mean that the bond-buying public in general, both through additional interest and smaller taxes, would gain $54,000,000, $104,000,000, or $79,000,000, whatever it may be, annually?

Dr. LUTZ. Let me understand what you mean.

The CHAIRMAN. Somebody must gain where the Federal and State Governments lose, either by way of remission of taxes, or increase of bond interest.

Dr. LUTZ. That means that the cost to the Government is going to be so much greater than what is to be gained.

The CHAIRMAN. To be gained by way of taxes?

Dr. LUTZ. Yes, sir. Now, I do not want to make a mistake. I do not mean to imply that this is going into the pockets of people that should pay income taxes.

The CHAIRMAN. I said the bond-buying public is gaining where the Government loses.

Dr. LUTZ. Yes. That will include trust funds and exempted institutions, and the Social Security Board.

The CHAIRMAN. The Social Security Board?

Dr. LUTZ. The Social Security Board, and individuals.

One of the reasons why you come out with the revenue result that looks to be less than the interest cost is the fact that you do not now, and are not likely in the future to tax all of the interest paid. You see what I mean.

For instance—and I am quoting from memory without going into the exact figures—but there is something like 250 million to 300 million dollars paid to completely exempt holders.

Now, as a matter of fact, that would make me suspect that Dr. Magill's figure is a little better than mine as to the amount of revenue the Federal Government would get from the taxation of State securities, because if we think about the tax being diverted, then, of course, the revenue and the interest must, or should, about equal each other.

Now, since most of this interest that cannot be deducted is in the hands of institutional investors, and, if you could tax it, it would be subject to the exemption, and if you calculated the tax on that interest now paid to the exempted institutions, say 16⅔, interest which would be the minimum, if you could tax all of that interest, it would produce about 40 million, and if you add that $40,000,000 to Dr. Magill's estimate, you get $110,000,000, and you would just about wash out the $113,000,000 cost.

The same would be true on Federal revenue against Federal interest.

If you would apply the corporate-tax rate to the amount of Federal interest that goes into these immune and exempt interests, you would get something like $50,000,000. I might say, in using this estimate, as to the probable yield derived, that it has to take account of the investor discounting any possible future tax increase.

You mentioned about the increase of State income tax rates, and that is in point. You see, if the investor says "I have got to discount not merely the present schedule of State-income-tax rates, but I have got to figure on every State in the Union going to a scale like that in California," he is going to react even more vigorously against the present yield basis, and he is going to demand an even wider spread on that point.

Now, just one other thing about this part 2. I have taken the position in that report, Senator, that the existence of these tax-immune and tax-exempt securities is not an easy way of escaping from the tax burden, except for those persons who may hold these securities beyond the breaking point of income.

Now, under the conditions that prevailed in 1938, a man had to have an income of somewhere around $54,000 or $55,000 a year before he

began to gain from ownership of tax-exempt securities over what he would be in pocket if he owned good corporation bonds.

Senator TOWNSEND. Do you happen to know how many people are above that bracket?

Dr. LUTZ. Yes; I went into that in 1936, the statistics of the income of individuals, and it showed that there were some 12,975, or 12,795—the figure is in the report—of persons with incomes above $60,000 a year.

Now, this is interesting also, that as to these individuals, the 12,900 who had net incomes in 1936 of $60,000 or over, they reported taxable income of over a billion and a half, and they had levied against them more than $650,000,000 in income taxes.

The CHAIRMAN. A little better than 30 percent.

Dr. LUTZ. Yes; of tax that they were paying.

As a matter of fact, I would consider that fairly definite evidence that, by and large, the group of individuals with incomes above $60,000 were not evading income tax.

And all of the evidence that we can get from estate tax returns, which is evidently throwing light upon the distribution of securities in the estates, that have been filed back to 1926 would indicate that there is a very small proportion of the trust estates, or those whose estates have passed through the mill in the last 2 years, invested in any kind of tax-exempt securities.

Put that together with the figures that have just been brought out, and the ownership of tax-exempt securities becomes an incidental matter. A man does not become rich by buying tax-exempt securities, and, as his estate increases, he seeks to diversify it more or less, and he buys Federal, local, or State bonds, for one purpose or another, and while one of those objectives may be the diminution of tax, nevertheless, it is not the only purpose. So these people do not own all of those tax-exempt securities.

The percentages are given in the report of the distribution of these estates, and, as I recall it, from all estates it is something like 5 percent plus on the net of the gross estates over a million dollars, and it is 9½ percent and a fraction for those under $1,000,000.

Senator LOGAN. Now, you suggested the reason why men invested in tax-exempt securities. I have never thought that they did it for the purpose of evading income taxes. Don't you think that there are many in that class who desire to be exempt from loss, and they can stay out of business and allow the Government to pay them interest, when, otherwise, they could not do that, and would have to go out and hustle to maintain their fortunes?

Dr. LUTZ. I confess to you that my acquaintance among that class of society is not extensive enough to enable me to tell you why they do it.

The CHAIRMAN. And you are from Princeton.

Dr. LUTZ. Perhaps I should stand corrected, but still I cannot, even though I am from Princeton.

Senator LOGAN. What I would do if I had any money—I do not expect to have any, but if I should have some—I guess I would put it in tax-exempt securities, and I would never think about tax-exempt securities as an evasion of tax, but I would be afraid somebody would take my money away from me if I went out into the business world.

Dr. LUTZ. I may say that this is rather a seductive line of thought that you have just suggested, and I would say, if it had the broad appeal that you and I together would see in it, that would seem to indicate, off-hand, that everybody who had a very large amount of money or wealth would sell all of their goods and buy nothing but tax-exempt securities, and they would not have to worry any longer. While it is true here and there we do hear this story and get the evidence of such and such an estate having nothing else but State and local bonds, if we take the broad picture of people of wealth in this country, it does not stand up. They own three or four times as much corporate stock as they own of tax-exempt securities, and they own almost as much in the way of taxable bonds of corporations as they own of tax-exempt securities.

Senator TOWNSEND. At any rate, according to your figure, there would only be 12,000 or 13,000?

Dr. LUTZ. So far as I have been able to estimate, that is true.

Now, I will pass on to the point I was going to make with respect to progressive taxation. Congress has already seemed to indicate that they do not put progression ahead of anything else. As you know, we have had in the tax laws for many years some kind of a tax on capital gains.

There has always been the persuasive argument that you should tax long-term non-taxable gains, and if anybody realizes a long-term non-taxable gain, they should rush up to the tax office and pay the tax on their non-taxable gain, for otherwise we are breaking down the income-tax progression.

But I think Congress has been wise in saying there are considerations that would not justify strict progression. You have also done it in charitable contributions. A man with an income of $1,000,000 may give away as much as $150,000 a year, and it will cost him, to give it away, something like twenty-five to thirty thousand dollars, so that he can get a great deal of credit for being a public benefactor at a low cost.

The argument has been made that there is a diversion of funds from enterprise, and this is an argument that has been urged over the years in this whole discussion on tax-exempt securities.

I think the figures as produced in the report, based on the estate-tax returns, would indicate there is no concentration of investment in tax-exempt securities.

I think, if we are to accept the argument that it is the tax-exempt securities alone which are responsible for the diversion of funds from enterprise, we would have a great deal of difficulty in explaining the situation apparent between 1920 and 1930, because all of the available statistics with respect to the growth of capital investment during the twenties, at a time when there was also a provision for tax exemption, and tax immunity—all of that evidence shows that during the twenties there was an enormous increase of investment of capital in enterprise and that capital was abundant. In the last few years capital has not been abundant. As a matter of fact, between 1932 and 1937 the State and local debt increased by only 150 million, and the great bulk of the State and local borrowings occurred during the twenties, when the same great increase in capital investment was under way. If there had been a diversion of enterprise capital, I do not think that we can say it has been due in recent years to State and local borrowings.

Senator BYRD. Should you not consider in that calculation the Federal borrowings?

Dr. LUTZ. Yes, Senator. I was just going to add the statement that if one believes there has been a diversion, you would have to look elsewhere than State and local borrowings since, say 1932, to reach the explanation for it.

Now, as a matter of fact, I think that it is capable of demonstration that if there has been a lack of enterprise capital today, it has nothing to do with the tax status of public securities, and a great deal to do with the general Federal tax. That may not be a pleasant topic at this point or under these circumstances, but I think we should be frank enough with each other to admit that the present general tax rate, the present provision with respect to net losses, and that beyond that the present estate tax rates are sufficient to provide ample discouragement in the matter of capital for enterprise.

Senator BYRD. Should you not add also the matter of future taxation?

Dr. LUTZ. I will add that, and I will also agree with Mr. Hanes and Mr. Wenchel, who have emphasized this particular point, that the country needs a release of funds for new and risky investment. That is the only way we could ever get rid of the relief load. We can not get capital into those channels without a great many changes in the tax policy, and some other changes that it would not be good to go into at this time.

Now, I did cover in the report the possibility of State and local and governmental extravagance. And there is the question of tax immunity, and, to uphold the position, we must remove the expenditures in order to curb extravagances. There is going to be a considerable increase in interest cost, and, if we are going to get increased public borrowings, we must get a considerable decrease in interest cost, and in order to consider whether that is going to happen, I should think we should look at the reasons for the public borrowings heretofore.

I am not going into the Federal situation, Senator, but I am here talking about the State and local borrowings. I do not think we can at this time go into all of the reasons for the Federal borrowings, and the fact as to whether the Government has to pay a higher rate than it has heretofore, but, in the case of State and local borrowings, I think that the record probably shows, by and large, that those debts have been incurred in response to a general or apparent need, which was a need on the part of the people for certain service, a certain improvement project, and certain forces outside of their control.

Now, take the question of highway borrowings: Down to 1912, there were only two States that incurred any debt for State highways, and they were New York and Massachusetts, and that was a very small amount. You see now what has happened. The automobile came, and it has improved so rapidly and cheapened so rapidly that States, counties, and municipalities have had to improve the highways, due to the fact that the people would not put up with the roads good enough for the horse and buggy but which were not good enough for the high-powered automobiles, so that forced the change.

They might have spent too much, but I do not think you can prove, by and large, that it was spent any less economically than any of the other governmental spending.

If anyone wants to stand up and say that all government is inefficient, I would not want to get into the opposition fight, but, after all, I think they spend it as well as the rest of the money is spent, and they spend it for roads, schools, district drainage, and all sorts of improvements, and they have got to keep on spending it.

Right here, Congress passed, last year or the year before, the Low-Rent Housing Act, and I need not say to you gentlemen that that act is filled with tax exemption; it is based upon it, in fact. The National Housing Authority is exempt, generally, and then the act goes on with all sorts of exemptions and grants to public housing, and every one of those grants is based upon predicates which influence tax exemption.

So, I say, if the whole tax-exemption program is knocked out, as a result of changes under discussion here, you can see for yourselves what it is going to do to such a program as low-cost or low-rent housing.

The CHAIRMAN. Let me say, Dr. Lutz, that I happened to have been in the House Banking Committee during the time that these exemptions that you speak of arose, and I want to say to you that there has been a steadily growing opposition in House committees and Senate committees to those exemptions, and one of the reasons why this committee was formed was a growing opposition to tax exemptions by these governmental agencies. That is one reason why we are here today.

Dr. LUTZ. As to that, I could not speak here today. I merely mentioned it to have brought out to the committee that you are coming head-on with certain other policies which seem to point in another direction, and if you remove this exemption, and say that you are going to accomplish this new social proposition without tax exemption, there is no question but that somebody else is going to have to pay for it, and I do not think it is going to be these people with incomes of over $60,000.

The minute that you put your finger on it, it is quite likely to get out from under you. It is like trying to pick up your shadow.

If we can reasonably say that a certain amount is going into these securities now, you have to ask yourselves what will be the effect of a tax. The only way that you can get a large amount of revenue is on the assumption that it will stay there subject to the tax, and you will have to prove that. In fact, one of the ways I have used of estimating the revenue we now have is that we will get so much revenue if this interest is received and distributed in the same way that the interest is now received, and if you will look at the ownership of these exempt securities, and the interest received, you will find that it is up in the big bracket. To say that we will get a very large capital revenue is, to a considerable extent, wishful thinking.

If there are no other questions, I will conclude at this point.

The CHAIRMAN. Thank you very much, Dr. Lutz. We will now resume with Mr. Tremaine.

STATEMENT OF MORRIS S. TREMAINE—Resumed

Mr. TREMAINE. If it please the committee, it would seem unnecessary for me to review in detail the conclusions so competently put before you by Dr. Lutz. I wish, however, to state for the record of

this committee that I am convinced of the soundness of those conclusions.

I wish to emphasize his conclusions are sound and well on the safe side. After you have thoroughly reviewed them I feel certain that you will agree that the popular misconception about the evils of tax exemption has been finally laid to rest. If Dr. Lutz has erred at all in arriving at his conclusions, it would be on the side of conservatism. His estimates on the increased costs of financing, I believe, are far lower than they would prove to be in actual practice.

New York State long-term bonds today would sell about a 2-percent yield. There undoubtedly would be an increase of three-quarters of 1 percent. That would be over 35-percent increase in interest cost to the State, and that would be the lowest increase I think we could look forward to. Referring to your question of Dr. Lutz, three-quarters of 1 percent I am sure is a very conservative estimate. Mr. Hanes' estimate that the increase would be six-tenths of 1 percent referred to the short-term debt. That is relatively a small item, and the interest on it relatively small.

If it is the intent to soak the bloated bondholder, this proposal is certainly not the way to achieve that end. On the contrary, it would tend to play into his hands at the expense of the ordinary local taxpayer. The best way to prove this statement is to see how this proposition works out in actual practice. Let us take a simple illustration.

For some time the State of Ohio has imposed a 5-percent tax on the incomes from the municipal bonds of that State. Naturally, the tax does not apply to bonds issued prior to adoption of the law. Consequently, side by side in the bond market there are daily dual quotations of tax-exempt and taxable bonds of the same municipalities and of similar basic values. Recent tables of such quotations have come to my attention.

In one instance, in the case of Cleveland bonds, the quotation showed a price differential between tax-exempt and taxable bonds, of the same city and of the same maturity, amounting to as much as five times the amount of the tax. I was reliably informed just the other day that in the case of Cincinnati bonds—one of the outstanding municipal credits in the country—the price differential is usually about twice the amount of the tax. Of course, the differential would vary according to the credit rating of the municipality concerned. It would be much harder on the poorer municipalities than the rich ones.

Who pays this price differential, represented by the extra interest cost plus whatever margin of safety the market may dictate? Certainly not the bondholder. He is obviously benefited by the extra net income. The only person who must pay it is the ordinary taxpayer in the municipality concerned, upon whose property the excess cost must be levied.

Why does the market adjust itself to the tax differential with such a wide margin to spare? The answer is simple. The purchaser of a bond maturing, say, 20 years hence, naturally does not know whether the current 5-percent tax will continue to obtain, or whether it may be raised to 10 percent, or 15 percent, or some other percentage before his investment is finally retired. So, in the face of this uncertainty, the purchaser naturally hedges on the price in an endeavor to cover any possible future eventuality.

The Federal Government and the States have already tapped so many sources of taxation that the municipalities are left with the general-property tax as virtually the only resource left by which to finance their local budgets. Now, if through this proposal the Federal Government comes "muscling in" on this last resource of the municipalities, I believe it will cause very serious consequences.

One of the most iniquitous phases of the proposed statute concerns the so-called "reciprocity" by which the States would be "permitted" to tax Federal securities. This poses the question of where, under this proposal, do the municipalities fit in?

Of our total public indebtedness in the State of New York for the year 1937, over $3,160,000,000 was represented by municipal debt on which their citizens were paying interest charges of approximately $122,700,000. The municipalities of New York State would, therefore, be faced with the possible increased interest costs of about $30,500,000 a year. I believe it would be much more than that, but I want to be on the conservative side.

Now, while the Treasury Department's proposal purports to be reciprocal as regards the States—and I think the Senators will agree that Dr. Lutz's report has completely exploded that fallacy—it doesn't even pretend to hold out any hope for the municipalities to get even by taxing Federal securities. Whatever, therefore, may be the plight of the States under this proposal, it is the property owners in our cities and other local units who would really "take it on the chin." Many of the cities which do not enjoy the credit rating of the State would be obliged to pay additional interest costs in excess of 1 percent. As Dr. Lutz has pointed out, it is quite possible that some of them would encounter serious difficulty in finding investors in their securities at all under existing legislative restrictions as to interest rate and terms of sale.

In 1933 the State of New York alone financed 40 municipalities that could not finance themselves at all, for the rate was about 6 percent. The State did take up these securities and financed them, all perfectly sound municipalities, but they could not get any money.

I understand the question of "reciprocity" will be dealt with by the attorneys general of my own and other States. However, it is perfectly plain, even to a layman, that there can be no reciprocity in a statute that would establish the power of the Federal Government to tax the States while at the same time asserting that it could not itself be taxed without its consent. Once that theory is established, it is perfectly apparent that any future Congress could at any time throw off the burden of State taxation of Federal securities by simply repealing the consent.

Indeed, if I were a responsible Federal officer, I would ask whether the Congress is willing to subject Federal securities for all time to the future uncertainties of 48 State tax systems. Thus, I may suggest that the committee consider what would happen if, in the course of some State economic experimentation, some States should in the future impose an arbitrary and unreasonable tax on the income from all securities? Could Congress then withdraw its consent to such taxation of Federal securities, issued while such a statute as the one proposed was on the books? Of course, I suppose the Treasury Department has figured out all the answers to such questions. But these possibilities suggest that even from the standpoint of the

Federal Government, there are certain "stop, look and listen" signs to which the committee might well give heed.

In conclusion, may I simply state, as they say in the legislative halls, that I desire to be recorded in the negative.

The effect of this change, Senator, would be an immediate increase in the interest cost and a very slow gain in the revenue to the Government. I have under my control the investment of $260,000,000 of State investment funds, and $115,000,000 of that is for the employees of the State retirement system. Naturally if this law is enacted we would get a higher price for what we have got, and we would immediately sell those securities to the people that wanted to seek a cyclone cellar.

As set forth by the Treasury, they show that you have got to get $10.70 to equal your interest on tax-exempt bonds. I do not know where you are going to get $10.70 except on a roulette wheel.

I am quite sure from a study of Dr. Lutz's report, and my own observations, and individual questioning of very rich men that the percent of tax-exempt bonds owned by the so-called tax dodger is very much smaller than is supposed. The fact is, and this is a matter of record, that within the State of New York and the city of New York investment of funds tax exempt, that you will find that the largest amount of bonds that belong to institutions that could be taxed would approximate about 11 billion dollars out of 40 billion, so that it looks like they are putting it over on us, taxing all of our securities, and only 25 percent of their own.

The argument presented by the Under Secretary on the question of tax-exempt securities seems to prove, beyond the peradventure of a doubt, that taxing municipal securities would raise the cost to the municipality.

It clearly shows why tax-exempt money could not be invested in enterprise; it shows the violent disparity between tax-exempt and taxable securities; it shows that capitalistic funds earned by a large producer cannot be reinvested in industry.

It proves that our present tax system is punitive rather than productive; to my mind it proves the necessity of modification of our punishment taxes to the end that the Government receive more net revenue; it proves that our tax system is not businesslike, and as our tax education gradually develops, a change is inevitable.

The Secretary quotes Presidents Harding, Coolidge, and Hoover and Secretary Mellon as favoring taxing public securities.

Their statements on the subject are obviously political gestures because of all the power they had to promote or possibly command a change. There is no record that it was ever used in a practical way. There is no evidence submitted that any of these gentlemen ever made an effort in this direction.

In their time there was no particular necessity for taxing these securities because they were not then used as a cyclone cellar.

In their time the yield on commercial securities was not much nearer, and the rates paid were so high, as a result, we have developed too heavy a debt service for our cities, towns, and villages.

The secretary clearly shows that any substantial producer would have to earn a gross of 10 percent to make 3 percent, and it is against the public policy of utilities to earn over 7 percent, so that any large owner or active person with ability would do well to earn 2 percent to

3 percent on his money net. In fact there are cases cited by one of our governors where a man with a gross income of $500,000 would have a better net income if he were on relief.

Perhaps this is the reason why we have so much unemployment.

Our present tax system, as shown by the secretary compels men with substantial incomes to keep away from enterprise, which makes employment.

In the United States today the indebtedness of all sorts from the small-loan companies up to the Federal Government itself has been decreased, and I believe that it is something over $30,000,000,000. We are not lending any great amount of money that could be called current capital in the proportion we ought to be lending it, and we have no enterprise capital on that account. That is clearly shown in almost every bank statement you can pick up. You can see no encouragement, and you wonder there is no commercial paper in the United States today as formerly understood, and that is the best evidence that this credit reservoir is piling up and ever getting higher. There is no reason to believe that we will obtain what we have got to obtain through the taxing system. This discourages enterprise.

The CHAIRMAN. Thank you very much, Mr. Tremaine. We will now hear from Mr. Henry Hart, vice president of the First of Michigan Corporation.

STATEMENT OF HENRY HART, VICE PRESIDENT, FIRST OF MICHIGAN CORPORATION, DETROIT, MICH.

Mr. HART. Mr. Chairman and gentlemen of the committee, the solicitor general of New York, the chairman of the Conference on State Defense, has requested me to testify before this committee as one familiar with the credit of States and municipalities. My experience in this field covers a period of approximately 23 years, during which time I have continuously specialized in the investigation and purchase of municipal securities. For several years I served on the municipal securities committee of the Investment Bankers Association of America, with 2 years as its chairman. I have also been a member of the board of governors and a vice president of that association.

It is generally admitted that legislation to tax the income from future issues of State and municipal bonds would increase the interest rates on such securities. Tax exemption has a greater bearing on the value of State and local government obligations than on the value of Federal Government securities. This is due to the higher credit standing of the latter, and the privileges and rights which are frequently extended to their holders. You have already been advised that in the opinion of those most familiar with municipal bond values, the increased interest cost to States and local governments on future issues of long-term obligations would be at least six-tenths of 1 percent. On a 3 percent bond this would increase the interest paid 20 percent. Many believe, backed by sound reasons, that the percentage of increased interest cost would be much greater on the bonds of smaller communities, and in many cases would prevent the marketing of such securities at legal rates.

Figures have been submitted to show the total increased cost to State and local governments, based on the amount of securities now

outstanding. If no attempt is made in the future to tax outstanding issues, it is of course admitted that this total increase in interest cost, as well as the total estimated revenues to the Federal Government, would not be realized until new bonds are issued to the amount of those outstanding. It is contended that the increased cost to local governments would be insignificant for many years. These arguments do not take into consideration the effect of the proposed legislation on refunding programs of some States and many municipalities. The primary purpose of my testimony is to point out a few outstanding examples in local governments where possibilities are available for refunding of certain outstanding obligations at substantial savings to local taxpayers. This would be accomplished by taking advantage of the privilege of calling in higher interest rate bonds and selling refunding issues at lower interest rates. If future issues are subject to income tax, while the bonds to be called are tax exempt, it is obvious that the principal advantage of such refunding would be greatly minimized, if not entirely eliminated.

It happens that my own city of Detroit furnishes one of the most conspicuous examples in the country of what has been accomplished by refunding of this kind, and what can be accomplished in the future. When the city got into financial difficulties in 1933 it made an arrangement with its creditors to refund a large part of its outstanding debt. The new bonds bore the same interest rates as the original issues, but included varying provisions, such as the right to redeem the bonds on any interest date. In the meantime, with the city's credit improved, it has been able to take advantage of the callable feature by retiring approximately $80,000,000 of its higher coupon bonds through the sale of refunding bonds at lower interest rates. This has resulted in annual savings of $1,142,000 in interest charges. The city still has outstanding over $115,000,000 of callable bonds bearing interest at 4 to 4½ percent. When credit conditions permit it plans to sell additional refunding bonds and retire the callable bonds. A saving of 1 percent in interest on $100,000,000 of these bonds would amount to $1,000,000 a year. With approximately 75,000 people at present on welfare and W. P. A. the city should not be deprived of the opportunity to cut expenses in other ways, such as interest costs. I believe that an attempt to tax future issues of municipal bonds by congressional action would prevent the continuation of this refunding program.

In addition to Detroit there are a number of other cities and counties in Michigan, such as Grand Rapids and Pontiac, with some $25,000,000 of callable bonds outstanding which are eligible for refunding in the near future at substantial interest savings. The State of Michigan has a bonded debt of approximately $72,000,000 all coming due within the next 5 years. While it has sinking-fund assets of approximately $50,000,000, a fairly substantial portion of such sinking fund is not readily marketable. This means that the State will be in the market for refunding bonds. If such bonds are taxable it will be reflected in the interest cost which the State will pay.

In Ohio I am familiar with a dozen prominent cities, counties, and school districts with $25,000,000 to $30,000,000 of bonds callable in the next few years, with an interest rate of 4 percent or higher. These include Akron, Cincinnati, Cuyahoga County, Dayton, and others.

The large overlapping units of government in Cook County, Ill., did some extensive refunding during the depression. Today they

have over $200,000,000 of long-term bonds outstanding bearing interest at 4 percent or higher and callable between 1940 and 1946.

The city of Philadelphia, which is having serious budgetary problems at the present time, has $107,000,000 of long-term bonds outstanding bearing 4 percent or higher interest, and callable on or before 1945.

Outstanding among the States which have refunding problems that might be adversely affected by this proposed legislation is Arkansas. Financial difficulties required this State to refund all of its obligations a few years ago. At the present time the State has outstanding approximately $80,000,000 of callable bonds bearing interest from 4½ to 5 percent, with nearly one-half at the higher figure. It is highly desirable that this State, with more limited resources than most of the States of the Union, be given an opportunity to reduce these heavy interest charges.

The examples that I have just cited aggregate over $575,000,000. There are several hundred other local governments which have callable bonds outstanding. A survey made last year by the Investment Bankers Association of America of municipalities with population of 5,000 or more which defaulted since 1929, revealed that over 500, with an aggregate debt of approximately $1,500,000,000 in 42 States, adjusted their difficulties largely through refunding. While the records do not show what percentage of the refunding bonds are callable, it is perhaps safe to assume that a substantial majority issued callable bonds. It is this group that has the greatest need for reduction in interest costs.

I do not wish to put undue emphasis on refunding to the exclusion of other legitimate reasons for new financing by States and local governments in the future. There is no reason to believe that there will not be a continuance of the necessity for the issuance of the normal amount of local government issues in the next few years. Welfare requirements and the cost of the replacement of worn-out or antiquated public works will continue. Financing for these and other purposes will probably cost an average of at least 20 percent more if the proposed legislation is adopted. The erroneous allegation that tax exemption encourages unnecessary public spending is refuted by the fact that the volume of local financing is usually no greater when interest rates are low than when they are high. In support of this statement let me cite the average figures for 6 years out of the last 10 as computed by the Bond Buyer. During the years 1929 to 1931 the average annual volume of State and municipal financing was approximately $1,359,000,000 and the average interest rate on the bonds of 20 large cities was 4.15 percent. For the years 1935 through 1937 the average volume was approximately $1,112,000,000 and the average interest rate was 3.13 percent. It is worth remembering that in the first 3-year period the interest rate was 1 percent higher than in the second 3-year period, although the annual volume was $250,000,000 greater. It should also be noted that the volume of outstanding State and municipal securities is not increasing appreciably, and that new issues are largely offset by those retired.

It has been suggested that refunding programs, such as those I have just mentioned, and urgent requirements for new financing, could be consummated without additional cost if the effective date of the proposed legislation to tax future issues was postponed for a year or two. I believe it will be conceded by the legal advisers for the

Government that the reasons they advance in support of the alleged legality of this proposed legislation would apply with equal force to the taxation of issues now outstanding. While the present administration may with all sincerity deny any intention of attempting to tax outstanding issues, there are many of us who believe that if the need for additional revenues becomes sufficiently urgent, the next step to be taken by future administrations will be to endeavor to tax outstanding issues. We also believe that if the first step is taken it will so undermine the confidence in the tax immunity of outstanding issues that the market on all municipal securities will be adversely affected. It would accordingly appear that it would not help the refunding programs, or the immediate new financing expense by deferring the effective date of the proposed legislation. Likewise, it would not benefit proposed refunding bonds by exempting them from the effectiveness of the law. A clear-cut constitutional amendment, eliminating all doubt as to the tax status of outstanding issues would appear to be the logical and constructive answer to the question before this committee. Such an amendment would protect the holder of State and municipal securities by putting it beyond the power of any subsequent Congress to impose taxes on outstanding bonds. It is clear that nothing short of such an amendment will provide such a guaranty. It is difficult to see what sound objections the Federal Government could have to submitting this proposal to the States in the form of a constitutional amendment for ratification. Debate on a controversial issue has always been the procedure of democratic government. The Treasury can have on objection to such debate if it feels sure of its ground.

The CHAIRMAN. We are ready to hear from you, Mr. Mayor.

STATEMENT OF HON. FIORELLO H. LAGUARDIA, MAYOR OF THE CITY OF NEW YORK AND PRESIDENT, THE UNITED STATES CONFERENCE OF MAYORS

Mr. LAGUARDIA. Gentlemen, I appear on behalf of the United States Conference of Mayors. This conference is composed of practically all of the cities over 50,000 in population, and it is supported entirely by public funds. We are nobody's godchild.

I desire to present, first, a statement from the various mayors throughout the country, and I will ask permission to introduce it at this point.

The CHAIRMAN. Certainly.

(The statement referred to follows:)

TAXATION OF MUNICIPAL BONDS—STATEMENTS FROM MAJOR AMERICAN CITIES

(Submitted by the United States Conference of Mayors, Mayor F. H. LaGuardia, president)

PHILADELPHIA

It is my belief that any such proposal, if made effective by legislation, would greatly increase the cost of municipal financing. This is especially so in Philadelphia which has long enjoyed a favorable position in the financial world. If the bill proposes to tax bond issues already sold or the income therefrom, the city of Philadelphia will very likely be required to reimburse the taxpayer for the amount of the taxes he will have to pay on the income derived from the city's securities.

Our contract with the bond buyer provides that he shall be protected against any taxes assessed upon the bond. A recent supreme-court decision of our State has held that a tax on income from securities is a tax on the principal. The city at present has approximately $550,000,000 of outstanding bonds and the addition of a tax on the income of these bonds in favor of the Federal Government would have to be added to the cost of maintaining the debt-service charges and would have to be paid not by the lender but by the taxpayers of the city of Philadelphia. On the other hand, if the bill proposes to tax the income received from future issues of Philadelphia bonds, the debt service charges on such bonds will be increased because the buyers will demand a rate of interest which will compensate the purchaser of the bond for the Federal taxes he will have to pay.

The proposed reciprocal right to tax Federal securities would be of no benefit to most municipalities for the reason that ordinarily municipalities are not invested with the power to levy taxes on such securities.

In addition, it would seem to be a futile thing to have the city of Philadelphia taxing its citizens to pay taxes to the Federal Government, either directly or indirectly, and the Federal Government taxing, inter alia, the citizens of Philadelphia to pay taxes to the city of Philadelphia. It could only result in an increase in the cost of administration of both governments with the burden being borne not by the lender but by the persons who are responsible as taxpayers for the maintenance of Government services in the municipality.—Mayor S. Davis Wilson.

St. Louis

This matter was discussed at a meeting of our board of estimate and apportionment, with the following conclusion:

We are opposed to Federal tax on the income from State and municipal bonds.

For the Federal Government to be permitted to tax the bonds of States or municipalities or the salaries of their employees is entirely inconsistent with the theory of the separate sovereignty of the State and Federal Governments, and the taxing of State and municipal securities would have a depressing effect on the credit of State and municipal governments.—Mayor Bernard F. Dickmann.

Denver

Taxing municipal bonds would just be another way of requiring the cities to make an additional assessment or issue more bonds to meet the situation.

I do not see where anybody would be benefited by taxing municipal bonds.—Mayor Ben F. Stapleton.

Pittsburgh

While the incidence of this taxation would be, by the figures given, less burdensome on the city of Pittsburgh than many other communities, still I am opposed to it as a deterrent to municipal financing and as raising the cost of municipal operations.

The principle applies in municipal affairs, as in any other, that additional taxes interfere with the operation of the business of the payer of taxes.

I would point out, however, that real-estate taxes would not necessarily be increased if the cities would adopt the principle of taking taxes off improvements and allowing the incidence of real-estate taxes to fall on site values. This practice is in effect in many parts of the world, including among other places the city of Johannesburg, Africa, and it is now under discussion in the London County Council as proposed to be applied in the city of London.—Mayor Cornelius D. Scully.

Milwaukee

With reference to the pending legislation to tax municipal bonds and salaries of public employees, I believe it the function of Congress to determine this problem. I would not have the slightest objection if it saw fit to tax both, provided the funds are returned to where they belong—to the municipal treasuries.

There isn't the slightest doubt but what every penny of the tax collected and, as Vice President Garner says, several times more, will be imposed upon government to pay by increasing interest. More than this, it is obvious that all this will fall on local governments which means the increasing of real-estate taxes.

The same is true in taxing the salaries of public employees. In our city at least, many of such public employees have long been underpaid and the same is true of officers. If a tax is placed on these salaries, unquestionably these salaries will have to be increased to make up the difference, at least substantially, if cities are to continue to attract anything like competent people. For this reason, as a matter

of justice, the money collected in the taxes should be apportioned back to the localities.

I need not say that the major portion of the revenue of all local governments is raised by a real-estate tax. It should take no argument on my part to convince anyone that the back of the real-estate owner has been broken by taxation. We are way beyond the limit, as evidenced by the fact of the tremendous delinquencies in real-estate taxes all over the Nation, particularly in municipalities. Milwaukee, which is reputed to have its financial housekeeping in good order, is still face to face with approximately $10,000,000 of real-estate tax in default and it is reported in the Milwaukee Sentinel that there will be no improvement in the amount of taxes that are now being collected over the amount collected last year. According to the clipping enclosed, our real-estate taxes will be in default to the tune of at least 30 percent.

I would favor the taxation of municipal bonds as well as the salaries of city employees and officers on condition that the Federal Government is honest enough not to commit burglary and virtually expropriate this money but to return the same to the municipal treasury where it belongs.—Mayor Daniel W. Hoan.

BOSTON

With reference to the taxation of income from Government bonds, I fully appreciate the argument that the removal of the present tax immunity from future issues will result in some increase in the interest rate and will also affect the price at which bonds may be marketed. Nevertheless I am forcibly impressed by the arguments of economists, adopted by several Secretaries of the Treasury, to the effect that the existence of an enormous reservoir of tax-exempt bonds creates a haven for capital seeking the privilege of tax exemption, and consequently removes from the market of productive enterprise a large volume of wealth which otherwise might be invested in such a way as to stimulate business progress. As under the existing tax structure municipalities must depend entirely upon the healthy condition of real estate, and as real estate in turn is directly affected by business prosperity, a program that will help to stimulate business or at least remove an obstacle from its progress is bound to benefit the cities even though indirectly.

Aside from the essential injustice of a system which gives unfair advantage to those best able to pay taxes for the support of government, this latter argument seems to me to outweigh the disadvantage which cities may suffer in the future in the form of increased debt service cost. Furthermore, feeling strongly as I do that easy money may be an incentive to unsound and excessive borrowing on the part of municipalities, I can see no great harm to come from the existence of a check on borrowing that would be provided by higher interest rates.

With reference to the taxation of government employees, I do not believe that this amounts to so substantial a problem as affecting tax revenues and economic factors as does the taxation of the income from government securities. In the first place, a very large percentage of all municipal employees will be found to come within the present exemption accorded individuals and families under the Federal tax laws. The number of department heads and other individuals on the municipal pay roll of the city of Boston that would be affected is comparatively small, and I believe Boston is no exception in this regard.

In the second place, as the President has said, there seems no good reason why such individuals enjoying a substantial public salary should not contribute their share to the cost of government as well as individuals in the employ of private business.

And, finally I do not forget that we are all citizens not only of the State but of the United States; and if we properly pay taxes for the support of the State government I do not see why I, as mayor, and others with a substantial income from public sources should not properly make our contribution directly to the cost of the Federal Government as well.

I do want to stress two things, however. One, which I believe is generally conceded, is that the removal of the tax immunity should be prospective in application and not retroactive. Good faith and common justice require it. The second is that careful consideration should be given to what compensatory advantage should be given to the cities in return for the surrender of tax immunity now enjoyed. The city of Boston, like almost all other cities, is limited almost entirely to real estate for its revenues. Here in Massachusetts we do receive by statute a distribution of the State's income tax, and to the extent that this continues and that the State's revenues from the income tax are swelled by the removal of the tax exemption from income on Federal bonds, Boston will benefit

accordingly. This is not true of all cities, however, and, of course, is not true with regard to those States that do not have an income tax. Furthermore, consideration should be given, because of these reasons, to the possibility of eliminating some of the tax immunity now enjoyed by Federal property, both real and personal, which exists within the tax limits of a city. This is a problem constantly growing in importance, all the more rapidly recently as the Federal Government embarked on housing programs, thus removing from the tax rolls real property that would otherwise be income producing for the city. In the city of Boston, for example, the amount of Federal real property exempt from taxation was figured at $75,118,000 for 1938 or the equivalent in taxes fo $3,102,373.—Mayor Maurice J. Tobin.

BUFFALO

This business of taxing municipal bonds and salaries of municipal employees involves a fine balancing of conflicting ideas. In the abstract, the average citizen can see very little reason for exempting such bonds and such salaries from taxation. The average citizen imagines the bloated jobholder enjoying an immunity from taxation which he does not deserve. He also sees the plutocrat investing in municipal bonds which are exempt from taxation, thereby diverting large sums of money out of business channels.

On the other hand, it would probably be to the disadvantage of the city in marketing its bonds, not to enjoy tax exemption on them. Furthermore, as a legal proposition, I am advised that if the United States Supreme Court is not going to depart entirely from principle of precedent, it will continue to hold that such exemptions can be removed only by a constitutional amendment.

It would seem to me that most, if not all, municipalities of the country will oppose the President's proposal. At the last council meeting, the Common Council of the City of Buffalo resolved to petition the House of Representatives for a public hearing on the bills involved.

The right of taxation by a government is necessary for the maintenance of the government and it is generally conceded. Such right of taxation is inherent in the States from and since the early colonial times. The States regulate the power of taxation by the various State constitutions. The whole power is by such constitutions delegated to the legislatures in some States and in others part of the power is reserved to the people to be exercised through referendum.

The Federal Government has no power of taxation except that delegated to it in the Federal Constitution approved by the various States. There is no inherent power in the Federal Government to tax other than such as is specified in the Federal Constitution or as is necessarily inferred from the powers granted to the Federal Government in the Federal Constitution.

The Federal Government and the various State governments operate in the same territory. Each State is limited to its territory, while the Federal Government operates throughout all the States. This duplication of governmental control by independent governmental bodies within the same territory has caused considerable friction and considerable controversy, all of which are commonly referred to as the question of State rights. The courts have quite uniformly held that the Federal Government has not the power to impede or harass the States governments by taxing the governmental activities of the States. Likewise, the courts have so held that the States have no power to tax the activities of the Federal Government when exercised within the constitutional limits.

The Federal Government may not tax a purely governmental activity of the State, nor may the State tax a constitutional activity of the Federal Government. This limit of the power of taxation has been held not to include activities of the Government or activities of the State which are not strictly governmental.

It is very questionable whether the right of taxation delegated to the Government would permit the Government to tax the income from State and municipal bonds, or to tax the income of the officers and employees of the State or municipal governments without amending the Federal Constitution, even if the various States by statute would concede to the Government such power.

The Federal Government has conceded to the State government in specific instances by congressional act the right to the State to tax Federal activities. The congressional act permitting the States to tax national banks is an example of the exercise of such consent. Taxes levied by the State against national banks pursuant to such congressional consent have been sustained in many Federal decisions.

The practical effect of carrying out the recommendation of the President would be to grant to the Federal Government the power of taxing all of the income from the bonds of the State and of its various political subdivisions, and also the taxing

of the salary income of the officers and employees of the State and its political subdivisions. It would grant to the State the power to tax income received from the bonds of the Federal Government and salary income of the officers and employees of the Federal Government within the territory of each State.

It seems to me that if the taxing of the respective obligations of the State and of the Federal Government as contemplated takes place, it should be by a specific amendment of the Federal Constitution and not by legislation enacted without regard to the Constitution or the decisions of the Court.

As a financial proposition, a greater advantage would accrue to the Federal Government than to the government of the various States. Especially is that true of the taxing of the salary income of officers and employees, many of whom are residents of the District of Columbia and could not be taxed by any State. The rate of taxation by the Federal Government would necessarily be uniform throughout the United States, while the rate of taxation within each State might vary greatly.

The taxing of the interest income of bonds heretofore issued and sold would be in conflict with the contractual provisions of the Federal Constitution. A rule of property has been established by the Federal decisions which in effect becomes a part of the agreement contained in the bonds. The rights of the owners of the bonds are to be determined in accordance with the law as it was judicially construed to be when the bonds were issued. Such rights may not be taken either by statutory act or by change of judicial decisions.

The object of taxing the income received from bonds is not so much to obtain revenue as to prevent the investment in untaxable securities. The rate of interest necessary to secure a sale of the bonds will necessarily be greater if the income is subject to taxation than if the income is not subject to taxation.

The amount that the Government would receive from the taxing of such income would naturally be equal only to the additional interest on taxable bonds. It would just be another Federal tax for regulation and not for income. The same would be true if the interest income on the bonds of the State and political subdivisions thereof be likewise taxed. In the long run there would be no perceptible gain by such taxation.—Mayor Thomas Holling.

Seattle

Aside from the question of the legality of such action by the Federal Government, without a constitutional amendment it seems to me that it is unsound in principle for the Federal Government to attempt to tax municipal securities. Certainly the financial problems of the cities are sufficiently acute under present conditions and present laws. Federal taxation of future municipal securities would, in my opinion, unreasonably aggravate the problem of funding and of refunding municipal securities.—Mayor Arthur B. Langlie.

Rochester

Should the income from municipal bonds be subject to taxation it would simply raise the interest rate with the result that local taxpayers would have to pay one-half to 1 percent more on money borrowed. This, in the aggregate over a period of years, would amount to a large sum of money.

Relative to the return to cities from the income tax, with the State government operating in the red, or on the ragged edge, there would be small chance for the local governments to receive any additional rebate on the income tax.—City Manager Harold W. Baker.

Louisville

The city of Louisville vigorously opposes any congressional action tending to change the tax status of future issues of municipal bonds. There are several prime reasons for this opposition:

(1) A proposed law would, in effect, place the issuance of municipal bonds in direct competition to high-grade corporate securities. The management of municipalities is subject to periodic changes. Not always for the better, but so long as we live under our present form of democracy, such changes are inevitable.

(2) Federal taxation of municipal bonds would increase the interest rate which cities would have to pay on future borrowings by at least one-half of 1 percent. This ratio of percent will tend to increase as the general price level of the bond market declines.

(3) Louisville has only two sources of tax revenue, namely, general property tax and license tax on business. At the present time we are levying the maximum tax on general property allowed under our State constitution and our license ordinances are in the process of revision whereby we will ultimately collect the maximum possible from business enterprises. At the present time the expenditure demands on the city are such that many essential activities are being curtailed far below the point of efficiency. Any additional financial burden placed on the city would tend to aggravate the ever-growing problem of unemployment and relief.

For these and other minor reasons, we are unalterably opposed to any legislation to tax, directly or indirectly, future issues of municipal bonds.—Mayor Joseph D. Scholtz.

COLUMBUS

There is no doubt in my mind but that the taxation of income from future municipal bond issues will raise the interest rate on said bonds. Any increase in the rate of interest to be paid on the bonds is, of course, an increased burden upon the taxpayers of the municipalities. This fact is obvious, in view of the necessity (and in Ohio the requirement by constitution), to levy a tax when the bond is issued of sufficient amount to meet interest and sinking-fund charges.—Mayor Myron B. Gessaman.

DALLAS

Press reports indicate that Congress will consider within the next few days the President's proposal concerning taxation of municipal bonds and salaries of public employees.

On April 30, 1938, I transmitted to you my views on this subject and a copy of my letter is attached. Subsequently, on August 29, the question was discussed by the Dallas city council and the following is their official action:

"It was moved, seconded, and carried that the city council go on record as opposing any Federal legislation designed to tax municipal bonds, and that the Texas delegation to Congress be urged to vote against any such legislation."

At that time all members of the Texas delegation were advised of the city council's action.

The above information is forwarded to you and we urgently request that you transmit this attitude to the Senate committee which is considering the President's proposal. —City Manager Hal Moseley.—

AKRON

The limitations of the Federal taxing power being boundless, it follows that the provisions of the act would be burdensome and dangerous, and, in my opinion, unwise from any viewpoint. Assuming that the States had reciprocal taxing power to an extent sufficient to yield a similar amount as that received by the Federal Government, the public would pay much greater sums than yielded because of increased interest charges for governmental financing.

Federal, State, and other governmental securities have always been an attractive investment principally because of tax-exemption features, and it would appear that the proposed legislation would destroy the reservoirs of credit heretofore enjoyed at low interest rates.

It would seem that there are other sources of tax revenues which would be available and much more desirable rather than enacting legislation providing for one government taxing another government. —Mayor Lee D. Schroy.—

MEMPHIS

The taxation of municipal bonds will place an additional burden upon municipalities which are already faced with very serious financial problems. Many think that this tax will be paid by the large holders of municipal bonds. Eventually, however, the tax will be paid by the municipalities through increased interest rates, and in turn the municipalities will have to pass this on in the form of taxation mainly to be levied on real estate.

Municipalities have been limited in the taxes they may levy, getting only what is left after the Federal, State, and other units of Government have levied their taxes. To place a tax on municipal bonds would place upon these cities a burden which I do not believe they can stand at the present time. Real estate is already taxed beyond any reasonable limit, and steps should be taken to adjust the tax burden rather than to augment it.

I hope eventually a committee will be formed to study the matter impartially to the end that we may arrange a more equitable distribution of taxes between the Federal, State, county, and municipal governments. Until this is done it is most certainly undesirable that additional tax burdens be placed upon our municipalities. —Mayor Watkins Overton.—

SAN ANTONIO

There is no question but that such tax on municipal bonds would constitute a burden on municipalities by reason of the fact that such bonds would command an undesirable market value without bearing a higher rate of interest than is now customary.

While such taxation would result in additional revenue to the Federal Government, we must not lose sight of the fact that such revenue to the Federal Government would be at the loss of the municipalities issuing such bonds. —Mayor C. K. Quin.—

OMAHA

This department protests strongly passage of law placing municipal bonds on par with taxable commercial bonds. Eliminating tax exemption for municipal bonds will add new burden for additional interest and practically stop municipal improvement activities and in many cases will bankrupt cities where improvements are solely financed by bonds. We urge you to use your influence and voice protest against such unreasonable bill. —Harry Knudsen, superintendent, department of accounts and finances.—

TOLEDO

I am writing to express the hope that you will oppose Federal taxation of the revenues or outstanding bonds of States, municipalities, or the agencies of either of them; that you will oppose Federal taxation of future State and municipal bonds except the same be authorized by constitutional amendment; and that you will support leagislation to prohibit retroactive Federal taxes on past years' salaries of employees of the States, municipalities, or their agencies.—City Manager John N. Edy.

TULSA

In addition to agreeing with the conclusions reached by many students, as based on the figures and information submitted to State and local government officials, I object to the proposed taxation for more serious reasons ingrained in our American institutions of government. It seems that the proposed taxation is but a step in the destruction of the separation of powers and division of government guaranteed and limited by our Federal Constitution to the inhabitants of the several States.

The maintenance of government of the individual States heretofore has not been of Federal concern. Bonds are locally issued for the establishing of schools, necessary governmental utilities, and functions for the maintenance of our free institutions. These bonds are paid by local taxes. To this local tax would be added a Federal tax without definite Federal benefit in return. A strict wall of protection should be maintained preventing Federal insertion over local affairs whether by detriment benefit or cooperation, as it would establish the precedent for widening the breach. The increased cost for local bonds means division of available funds from the purpose of the bonds.—Mayor T. A. Penney.

SYRACUSE

This proposal will, in the long run, be levied against those persons who pay taxes on real estate. Taking municipal bonds out of the tax-exempt class will raise the rate of interest on the bonds at least in an amount equal to the tax levied on the income. Because real estate owners pay the interest on these bonds, it is simple to see that they are the citizens who will suffer.

The city administration of Syracuse feels that the real-estate owners are already overburdened. Any effort to include them in additional direct or indirect taxation for maintenance of the Federal Government is unjust and will be deeply resented.—Commissioner of Finance T. E. Kennedy.

DAYTON

Reference to Federal taxation of municipal bonds, we have come to the conclusion that this should not be attempted without the authorization of the States through a constitutional amendment.—City Manager F. O. Eichelberger.

NEW HAVEN

It is the opinion here that taxing municipal bonds will add to the cost of municipal government and increase the difficulty of marketing such securities. I feel that the city is too heavily financially burdened now and no action should be taken by Congress to increase our burden.—Mayor John W. Murphy.

NASHVILLE

I am advised that on or about January 16, 1939, a special Senate committee will probably institute hearings on the question of whether or not a recommendation will be made to tax municipal bonds.

It appears to me that this is a direct blow to the already weakened and impaired financial structure of every American city. The inevitable result of such legislation is increased taxation upon the citizens of the various municipalities. The taxing of bonds of the cities will naturally result in investors demanding higher rates of interest, which will, of course, have to be met by the taxpayers of the cities.

Please leave no stone unturned in an effort to convince this committee that the American city is being financially crippled by the State and Federal Governments continually adding burdens and depriving municipalities of what has heretofore been sustaining sources of income. The future looks dark for the American city unless some assistance is rendered.—Mayor Thomas L. Cummings.

FLINT

From a long-range viewpoint the imposition of such a tax on municipal securities is bound to be harmful to the city of Flint in that it would cause the price at which new or refunding issues could be sold to decrease and would consequently require the imposition of additional taxes.

I would state that it is our opinion that the passage of such an act by Congress would be detrimental to the best interests of the taxpayers of the city of Flint. It would be another indirect tax taken from the taxpayers of the city to the detriment of local self-government.—Lloyd G. Kirby, director of finance.

YONKERS

If the income from municipal securities shall be made taxable, it will raise the cost of municipal financing to such an extent as to disastrously impede the ability of the cities to raise money on municipal bonds and notes, not only for the usual municipal purposes, but also for financing the relief of the destitute and the unemployed. The result of this will be an increased tax burden on real estate, real-estate taxes being the city's principal source of revenue. Another inevitable result will be to throw a greater burden upon the Federal Government, and the Federal Government will lose far more in destroying the power of municipalities to provide for the destitute and the unemployed than it will ever gain from putting into effect any unwise and heedless tax on municipal borrowings.—Mayor Joseph F. Loehr.

TRENTON

It has come to my attention that there will be introduced in the next Congress, bills to tax past years' salaries of Federal, State, and municipal employees; also to tax outstanding bonds of the State and municipalities, and a further bill to provide for the taxation of all municipal bonds to be issued in the future.

It is my impression that any one of those taxes would be oppressive and would only add to the already heavy burden of taxation that now confronts the American people. If municipal bonds are taxes it will be impossible for municipalities to function as there would be no purchasers for the bonds.—Mayor William J. Connor.

CAMDEN

As mayor of the city of Camden, I wish to voice strenuous objections to any such measure. The cities of the Nation are just beginning to emerge from the chaotic conditions which have plummeted them to the economic bottom in recent years and, in fact, in the past several months some of the cities have again lost ground and will require some time to recover. Our city, fortunately, has not yet felt the effects of the recession which the Nation is now experiencing, but we know that ultimately and inevitably we shall feel it's effects and any additional taxation which would be made necessary, if we are to raise the percentage of interest which we pay on municipal bonds, would fall very heavily on the shoulders of the tax-

payers at this time. No astute reasoning is required to realize that one of the most attractive features of municipal bonds is the fact that they are tax free. To compensate for the loss of this feature, it would be necessary to raise the interest rate payable on city bonds and this would make imperative an increase in taxes. It is my opinion that such a legislative measure right now would work havoc on all municipalities throughout the entire Nation. Therefore let me repeat that I am strenuously opposed to any such legislation.—Mayor George E. Brunner.

SPOKANE

I heartily concur in the conclusion that this taxation would be an additional cost to the municipality that would offset revenue accruing to the Federal Government.

This city would oppose the adoption of the proposed legislation to tax municipal securities.—Mayor F. G. Sutherlin.

NEW BEDFORD

After giving the matter careful thought and consideration, I wish to go on record as being very much against taxation of income from all future municipal bond issues.—Mayor Leo E. J. Carney.

FORT WAYNE

In my opinion, any further restrictions, whatsoever, by way of tax or by regulation, placed upon the sale of municipal securities, would—

First, increase the burden of their disposal upon the municipalities, and

Second, there would be imposed a greater tax load upon the taxpayers by forcing an increased cost upon the municipality, and the compulsion of the cities to give a larger inducement for their purchase.

This greater tax load would be caused by an increased interest rate. In other words, the municipalities would necessarily have to increase the interest rate in the same ratio as the tax imposed; and in the final analysis, the taxpayers of the city would be paying the tax rather than the holder of the bond. If would simply mean that you were placing an increased burden upon the shoulders of the already over taxed taxpayers of the municipalities.

If there is any attempt to pass a bill to include taxing of municipal securities under the alleged powers granted under the sixteenth amendment, I wish that you would voice my protest against it on behalf of the citizens of the city of Fort Wayne.—Mayor Harry W. Baals.

KNOXVILLE

With reference to taxing municipal bonds, I fear it would increase the rate of interest in such a way that it would tend to retard municipal improvements.—Mayor W. W. Mynatt.

SAGINAW

We have given some consideration to the proposal of the United States Government to tax municipal bonds. This matter has also been thoroughly discussed by the Michigan Municipal League, the Michigan managers' group, and the Michigan Finance Officers' Association, and it is the opinion of each of these groups that the taxing of municipal bonds will create a definite burden on local taxpayers who are now in most cases taxed to a point where it is difficult to meet their local tax obligations.

I cannot conceive of any benefits which may be derived by taxing municipal bonds, because it is apparent that the bond buyer will naturally bid a higher interest rate, at least sufficient to cover the Federal tax. In other words, the additional revenue obtained by the Federal Government will be paid by the local taxpayer indirectly with a higher interest rate borne by municipal bonds. Cities which are fortunate enough to operate on a pay-as-you-go basis will be relieved of this additional burden, whereas the less fortunate cities, having to finance on a long-term basis, will suffer.

We are now faced with the possible issue of three or four million dollars in sewage-disposal bonds, and the added cost on this issue over a period of 25 to 30 years will amount to a considerable sum. It seems to me that Federal income can be derived from sources which will be more equitable than the tax on municipal bonds.—City Manager L. P. Cookingham.

BINGHAMTON

Relating to the proposed taxing of State and municipal bonds, and after studying various reports, the picture is not a pleasant one to contemplate by those who have to shoulder the costs of municipal government.

The only conclusions I would attempt to draw would be general and in line with those already presented; however, I feel that it cannot be too strongly emphasized that a tax proposal of this nature should by all means be submitted to the States for their sanction. There is dynamite hidden in the potential abuse of this measure.—Comptroller Arthur J. Ogden.

HARRISBURG

Such action on the part of Congress would not only be uneconomical but also, in many instances, confiscatory.—Mayor John A. F. Hall.

ALTOONA

Members of council today instructed me to register our most emphatic protest against this latest move to increase the cost of local government.

For the past decade the city of Altoona has been exerting every effort to furnish service to this community within reasonable respect to the increasing demands and the diminishing revenues. At the same time we have been maintaining our credit because we realize that any impairment thereof will be reflected in increasing costs of government in the generations to come. More and more our sources of revenue are being tapped by State and Federal Governments and these same authorities have been adding to our costs of furnishing these services to our local people, without making any provisions for improved service.

This latest move, if made retroactive, would throw our present debt structure into chaos. For the future the increased cost could not be measured in dollars and cents because the moral effects on prospective sources of municipal credit would be tremendous.—William T. Canan, city controller.

OAK PARK

After reading and considering all of this matter I have only one comment to make and that is—any tax by the Federal Government on municipal bonds would accomplish only one purpose and that is, to increase the cost of municipal government. I do not think it is fair; if the Federal Government is to levy such a tax it should be done only after a constitutional amendment that has been adopted by the people, permitting the Federal Government to levy such a tax.—President James A. Howe.

TERRE HAUTE

There are two features of these municipal bonds that I would call attention to. First is that most cities are bonded up to within 25 percent of their statutory limit and all of these bonds have been issued as untaxable bonds. It would seem rather unfair if an effort is made to tax bonds already issued as tax free.

The other proposition is, if municipa bonds are to be subject to taxation the rate of interest will of necessity have to be increased.—Mayor Joseph P. Duffy.

FRESNO

There is engrained in the proposal of the Treasury Department at Washington to tax municipal bonds greater danger to American liberty than our people have had to face for more than three-quarters of a century. I am aware of the danger involved in the doctrine of secession. But that danger is passed and settled while the consolidation of all power in the Federal Government is a present day most serious matter.

There are two ways in either of which the American scheme of a federated government might be defeated. Formerly, the greater danger was in secession. But since the Civil War there has been a strong tendency to consolidate power in Washington; a tendency which, if unchecked, will result in the total subordination of the States to the central authority, and thus in the destruction of the federated plan of government. The most essential power of government is the power to tax. The founders of our Nation understood well this primary fact in civics. They had just successfully resisted the British Government in its unjust and unlawful attempt to tax them. They were careful and skillful in allocating

this power. The powers of the general Government were definitely circumscribed.

Before the adoption of the National Constitution the taxing power inhered exclusively in the several States. Without question, prior to 1787 the property of the citizen could not be levied upon by the central authorities.

In erecting a general government it was realized that such government must be given power to raise money to support it in its legitimate operations. But the way and the manner of collecting such tax money as it was empowered to raise were definitely outlined and particularly restricted.

Early in the history of the country it was assumed by some that the States retained coordinate powers of taxation even in those matters wherein the Nation had been empowered to tax.

But Chief Justice Marshall, in his famous decision in McCulloch against Maryland, pointed out that the National Government had been given supreme and exclusive powers of taxation over certain institutions and activities, while the States retained a like exclusive authority over other things.

When we remember that the great judge was a determined advocate of the doctrine of centralized power, we should attach the highest importance to his statement that "We have a principle which leaves the power of taxing the people and property of a State unimpaired. Judge Marshall was demonstrating that over imports and exports (except in certain specified instances) as well as over financial institutions and instruments of the Central Government that government had exclusive authority of taxation as well as of control; while over real property and its appendages the States retained all the rights inherent in sovereignty. Thus the Constitution stood until the income-tax amendment authorized the National Government to "lay and collect taxes on incomes from whatever source derived." This amendment, however, must be confined to the object specified, since the tenth amendment clearly states: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, respectively, or to the people."

Thus it is seen that it would take another amendment to the Constitution to empower the National Government to do what the Treasury Department is claiming that it has the power to do by act of Congress.

That the State laws and local ordinances embrace the whole of the law applicable to municipal bonds has been repeatedly upheld by decisions of the Supreme Court of the United States. When in the "era or repudiation," 10 years or so after the close of the Civil War many suits were brought to compel the defaulting municipalities to pay, the Supreme Court followed the law, upholding or declining to uphold the validity of the bonds, in accordance not only with State laws but with the interpretations put upon those laws by State courts. The entire history of the Constitution, the laws and the finances of the country is against the power claimed by the Treasury Department. The mere fact that such a power is asserted illustrates the dangers inherent in the steady and continued growth of authority by official Washington. Given the power affirmed and it would be an easy step to complete control over tax matters of every name and nature. Then with a central government spending money by the billions, with the national debt a lien on all property, real and personal, it is quite apparent that tenure to property in every community would become less and less valuable.

In the name of the property we still hold, in the name of the liberty we still prize, the attempt of the Treasury Department "to obtain an unwarranted jurisdiction over us," should be defeated.

With complete control over all the resources of the Nation, a ruler at Washington might easily perpetuate himself in power, beyond his term, should he desire to do so. There is no danger of this now; but no one can foretell the future. Our safeguard is to retain in the States such control as still remains with them.—William Glass, Commissioner of Finance.

HAGERSTOWN

Viewing the matter from a purely practical standpoint, it would appear that the contemplated step will not only reflect unfavorably upon State and county finances but will also be most detrimental to the fiscal affairs of municipalities. Municipal securities enjoy a low interest rate primarily because they are tax-exampt and are attractive to investors who wish to pay a minimum of Federal income taxes. If the tax-exempt feature is removed, the same investors will require a much higher rate of return on their investment, and the cost of money to municipalities will increase to a point where their securities will be required to yield a return comparable to that on private corporations.

Taking the municipality of Hagerstown as an example, I believe that where the tax-exempt feature eliminated from its bonds the rate of interest that it would be compelled to pay would be increased to approximately 1½ percent more on the principal than it is paying at present. Its bonded debt is approximately $5,000,000 so that this increase would equal to the sum of $75,000, which in turn would represent an increase of 20 cents per $100 (or 25 percent) over the existing tax rate.

As the city derives its revenue from the taxation of real and personal property and cannot levy an income tax, there would be no compensating increase in its revenue were its securities made subject to Federal income taxes, and the property holders and home owners of the community would be compelled to shoulder the additional burden. While Hagerstown is not faced with any refunding operations in the near future, and there does not appear to be any present likelihood of increasing its funded debt, the fact still remains that if on account of some emergency or otherwise the city were compelled to issue bonds without Federal-income-tax exemption, it would be a very costly proposition when compared to past financing.—Mayor W. Lee Elgin.

BETHLEHEM

Some time ago city council had this matter up for discussion. At that time it was the opinion of the members of city council that salaries of municipal employees should be taxed. Council, however, was opposed to taxing municipal bonds, for the reason that it would result in an increase in the interest rate on municipal bonds which would hereafter be issued. People today are willing to buy municipal bonds at a lower rate of interest than other bonds because they are tax-free and municipalities thereby obtain a lower rate of interest, which, of course, is a saving to the taxpayers. If municipal bonds are taxed, the purchasers of these bonds will want a higher interest rate and therefore the burden of these taxes will fall upor the municipality. I trust that I have made myself clear in the position assumed by the City Council of Bethlehem.—City Clerk Bertram L. Nagle.

LAKEWOOD

Under our constitutional system the guarantee that the Sates should remain forever free is the first premise of American Government. The defense of that independence which has been guaranteed to his State in the Bill of Rights is, therefore, the most solemn obligation of the office of the State attorney general. Upon him falls the duty of protecting the sovereignty of his State. If he fails in that, then his State constitution is but a local charter, and the State government which he represents becomes no more than a Federal province.

I most heartily agree with a statement made by Senator William E. Borah, of Idaho, when he expressed his oppinion that he did not believe Congress would have the power to tax State and city bonds, securities, or other instrumentalities of a State or city without a constitutional amendment. Even if such a law were passed without a constitutional amendment, as a matter of policy and aside from the constitutional question, it would be most unsound and would be a disaster to the States and probably a sad disappointment to the National Government.

I understand Attorney General Cummings made a statement to the effect that the principle of immunity protects the Federal Government against taxation by the States, but does not necessarily shield the States against the exercise of the supreme taxing power of the Central Government.

I understand another Government official has sweepingly asserted "the power of the National Government to tax * * * the institutions of the State." And that during the last session of the Supreme Court the Department of Justice submitted briefs in which they asserted the power to impose a Federal corporate income tax upon State revenues. If this would apply to State revenues there is no doubt but what it would include all subdivisions of a state.

Such claims as these, made by those in high places of the Federal Government, of a Federal power to tax the States and the cities, tear at the whole fabric of independent local government in America. They attack the fiscal integrity of your local units of government. They express a philosophy of centralization of power that is totally foreign to our conception of "an indestructible union of indestructible States."

If the Federal Government can tax the States, their status as free and independent sovereignties can be brought to an end. It has been stated that the opinion of Chief Justice Marshall that "the power to tax is still the power to destroy" is no longer a reality. I do not know of any other procedure that could more rapidly destroy the Federal Government or any of its states than the authority and power to tax, and especially so during economic financial conditions as have existed for the past 10 years and still continue to exist at this time.

It seems the Treasury Department is doing everything in its power to have Congress adopt the President's proposal to tax State and municipal bonds for the purpose of increasing Federal revenue at the expense of the State and its local subdivisions—which are now, in many, many cases, so overburdened with indebtedness that it will be many years before such local subdivisions can even pay the expense of their local government.

The general impression seems to be and may so appear on the surface that the proposed legislation is limited only to tax future issues of bonds. The question arises, if Congress should adopt the President's proposal and could tax future issues of bonds of States and cities, it would be a very simple method then to pass another bill and provide for the taxing of present outstanding issues and would, no doubt, be adopted without delay.

The apparent reciprocity of the proposed statute as between Federal and State governments does not seem to be correct, in that there is a difference as between an assertion of a power to tax and an extension of a permission to tax. The statute seeks to establish a Federal power to tax the bonds of States and cities. It is based on the contention of the Attorney General that the Central Government has a supreme power to tax the States, but that same opinion denies any power whatsoever of the States to tax the securities of the Federal Government.

It is the consensus of many of those who have given consideration to the proposed statute that Federal taxes of State or cities securities would place an additional burden on the cost of State and municipal financing of at least 25 percent. Such an increase would represent an increased cost to the States and cities of millions of dollars each year. It is not difficult to determine that if those who invest their money in State or municipal bonds are required to pay a Federal tax that the authorities issuing such bonds would be required to pay higher rates of interest and would result in the increased cost of State and municipal financing.

I understand the proposed statute also provides for the taxing of municipal revenues of all kinds. If such is the case, then water, light, transportation, and other publicly owned utilities would have to increase their rates because of such revenues being subject to Federal tax. Is it not a fact that if the Treasury Department made a demand that such agencies must pay such a tax on their revenue that the rates for service provided by them would automatically increase?

In a brief submitted to the Supreme Court of the United States the Attorney General asserted that certain municipal corporate agencies of the State are subject to the Federal corporate income tax. The municipal agencies, he challenged, were entirely owned and operated by sovereign States. The properties and their revenues all belong to the States—yet the Attorney General asserted that the Commissioner of Internal Revenue had the power to dip into the State treasuries to tax them.—Mayor A. I. Kauffman.

JACKSON, MISS.

It has been the general belief that to tax municipal bonds it would be necessary to amend the Constitution. Now, however, it is proposed to tax municipal securities under the sixteenth amendment, which provides for the Federal income tax "from whatever source derived."

I am opposed to the Federal Government taxing municipal bonds and I believe every local taxpayer is opposed to it because this is but another illustration of the Federal Government and the State government passing the "buck" to the local government and placing an additional tax upon the municipal taxpayer. If the Federal Government places the tax on municipal bonds, it will mean an increase in the rate that Jackson and other municipalities will have to pay on bonds from one-half of 1 percent to perhaps 1 percent, or more. The municipal taxpayer would have to stand this burden.

I want to request and urge that you use your influence, work against, and vote against the Federal Government's passing this tax to municipal taxpayers, not only in Jackson, but throughout the State and Nation.—Mayor Walter A. Scott.

HAZLETON

I am anxious to be included among the many mayors of our American cities who protest very vigorously against the contemplated Federal tax on municipal securities. It is almost trite to say that our municipalities are sorely pressed in their problems of finance. With very few exceptions our municipal officers are struggling to lessen the tax burden on local real estate.

For the preservation of interest in real-estate ownership, it is essential that some relief be provided for the sorely pressed owner of real property. Any tax by the

Federal or State Government affecting municipal securities will of necessity be passed to real-estate owners.

The Federal and State Governments in my opinion should give attention to providing new fields of taxation for municipal bodies so that the much abused real-estate owner will have some opportunity of finding a ray of light in the darkness of his own local taxation. It strikes me as being exceedingly unfair even entirely unjust on the part of the State and Federal Governments to completely control all sources of taxation and gradually decreasing municipal income as a result of their supertaxation powers.

You may include in a statement going forth from the United States Conference of Mayors to appropriate congressional committees the vigorous protest of the city of Hazleton against Federal legislation which will affect our municipal vitality.—Mayor James P. Costello, Jr.

Portland, Maine

Federal tax on income of State and municipal bonds.—Such a tax, always considered unconstitutional heretofore, would raise substantially the interest rate on such bond issues. It would thus cause a rise in the local tax rates, being in effect an indirect tax on local real estate by the Federal Government. Real estate certainly carries enough of the tax load now without impositions from Washington.

While this tax might tend to discourage issuance of local bonds, an end perhaps to be desired, nevertheless, this would be contrary to the Federal policy, as the Federal Government agencies have been urging local communities to finance—with local bonds and Government subsidies—various public improvements in order to provide employment. Thus the various branches of the Federal Government are working at cross purposes.

Presumably the State could also tax incomes from Federal Government bonds and thus narrow the market for them with perhaps higher interest rates tending to offset the revenue derived by the Federal Government from the income of State securities. Inasmuch as both of these proposals are essentially Federal taxes on local real estate, which is already sadly overburdened, the Federal Government, in fairness to make these tax innovations somewhat reciprocal, should allow the local communities to tax the Federal real estate located in that community. Such property demands all kinds of local services, such as police and fire protection, street lights, street paving, etc., and such reciprocal action would somewhat soften the financial aspect to local real estate.

Again, the inconsistency of the Federal Government is glaring. On the one hand, the Social Security Board attorneys rule that the State and municipal employees can't be covered by social security as they are unable to tax their incomes without a constitutional amendment. The Treasury Department attorneys, on the other hand, rule that such incomes can be taxed for Federal revenue. One or the other group of attorneys is surely wrong.

This tax would still further break down the fundamental theories of our constitutional government as between the rights of the States and the Central Government, and should be exercised only after due amendments to the Constitution.—City Manager James E. Barlow.

East Chicago

As to the taxation of the municipal bonds, I am opposed to such a proposal. The municipal bonds themselves, are a tax on the people, and I can't understand how they could be taxed again. I think that there are other sources that could be taxed without burdening the general public with a tax on bonds that are tax themselves.—Mayor Frank Migas.

Lancaster

The city of Lancaster strenuously disapproves of the proposed action of the Federal Government to tax municipal bonds.

The bonded indebtedness of Lancaster at the present time is four and one-half millions of dollars and our budget is so constructed that we have little, if any, left over at the end of the year. Taxation of municipal bonds would mean an increased expenditure of $22,500 and would necessitate the raising of the millage 1 mill.

We feel that the burden of this additional taxation would eventually fall upon the poor taxpayer who is now overburdened to a serious degree. In addition, such proposed taxation would make the bond market practically worthless, as

investors would sidestep bonds and place their money in certificates of deposit or some similar investment that would not be taxed so heavily.

We are of the opinion that the entire plan is entirely out of reason.—Mayor D. E. Cary.

CUMBERLAND

For your information, the officials of the city of Cumberland, are opposed to this form of taxation. Taxation by the Federal Government of municipal obligations will increase the cost of borrowing money and tend to destroy a market for municipal securities. Aside from this, such a move would again be a long step in the direction of complete federalization of the Nation.—Mayor Thomas W. Koon.

BALTIMORE

Such proposal would result in increasing interest rate of municipal securities. On basis of generally conceded conservative rate of increase Baltimore debt service would increase possibly million and a quarter, and tax rate increase 11 to 12 cents. Generally accepted fact among municipal finance officers and investment houses throughout the country that the revenue derived by the Federal Government would impose a burden on local governments far in excess of the revenue derived by Federal Government.—Herbert Fallin, budget director.

Mr. LAGUARDIA. As to some of the cities, instead of the statements of mayors or the statements of financial officers, there are resolutions by the city council, and I would like to put that in at this point.

The CHAIRMAN. That may be received.

(The resolutions referred to follow:)

TAXATION OF MUNICIPAL BONDS—COUNCIL RESOLUTIONS OF MAJOR AMERICAN CITIES

(Submitted by the United States Conference of Mayors, Mayor F. H. LaGuardia president)

LOS ANGELES

RESOLUTION

Whereas concerted efforts are now being made to subject to Federal taxation the income from municipal bonds and the salaries of municipal employees, and to give such taxation retroactive effect; and

Whereas the taxation of income from municipal bonds would inevitably result in increasing the cost of local government and, insofar as retroactive, would work a serious injustice to persons who paid a higher price for such bonds, relying upon their exemption from taxation than they otherwise would have paid; and

Whereas, the retroactive taxation of the income of municipal employees would be financially ruinous and unfair to those employees and injurious to the communities in which they reside; now, therefore be it

Resolved, That the city of Los Angeles—

(1) Condemns as unfair and oppressive the imposition of retroactive taxes upon the income from municipal bonds and municipal salaries;

(2) Condemns the unwarranted extension of Federal power and the weakening of local government through the taxation of income from municipal bonds to be issued in the future;

(3) Urges that if equitable and nonretroactive taxation of the income from municipal salaries hereafter be contemplated such taxation be authorized only on the condition that the State be afforded the reciprocal right to tax income from Federal salaries;

(4) Is convinced that the radical change in relationship between local and Federal Government that is inherent in current efforts to tax municipal securities and salaries should be accomplished only by sanction of the people as a whole, expressed through well-considered amendment of the Constitution, and not by judicial lawmaking; be it further

Resolved, That all Members of the Congress are urged to consider carefully the views herein expressed, and to lend their constant support to all proper legislative means for carrying them into effect.

The city clerk is hereby instructed to transmit immediately a copy of this resolution to every Member of the House of Representatives from districts located in Los Angeles County and Senators representing the people of the State of California.

I hereby certify that the foregoing resolution was adopted by the Council of the city of Los Angeles, at its meeting held on January 18, 1939.

RALPH E. DAVIS,
City Clerk of the City of Los Angeles.

DETROIT

(By Councilman Dingeman)

Whereas it has been proposed that Congress enact a statute attempting to levy an income tax upon municipal securities; and

Whereas Federal taxation by act of Congress of the income on bonds of the city of Detroit would materially increase the cost of municipal financing and seriously embarrass the orderly progression of its refunding program; and

Whereas during recent months it has been asserted that a Federal power to tax the revenues of State and municipal instrumentalities exists, founded upon the theory that the Central Government has the supreme power to tax the States; and

Whereas the taxation by the Federal Government of the revenues of municipalities would seriously threaten their existence and is contrary to the basic system of established government in the United States; and

Whereas as a result of a recent decision of the Supreme Court of the United States, State and municipal employees may be subject to the payment of Federal income taxes, retroactive on salaries earned from 1926 to date; and

Whereas retroactive taxation has always been regarded as contrary to American principles of government, grossly unfair and inequitable: Now, therefore, be it

Resolved, That the city of Detroit is strongly opposed to the taxation of State and municipal securities by the Federal Government unless the consent of the State is first obtained by a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting any Federal taxation of State and municipal revenues other than bonds; and be it further

Resolved, That the city of Detroit hereby urges its Senators and Representatives in Congress to support legislation prohibiting retroactive Federal taxation upon the salaries of State and municipal officers and employees; and be it further

Resolved, That the corporation counsel and controller of the city are directed to cooperate in every manner possible with the efforts now being made by various organizations, in furtherance of the foregoing objectives; and be it further

Resolved, That the clerk be, and he hereby is, instructed to forward certified copies of this resolution to the Senators and Representatives of this State in Congress.

Adopted as follows:

Yeas—Councilmen Breitmeyer, Dingeman, Ewald, Kronk, Lodge, Smith, Sweeny, and the president—8.

Nays—None.

[True copy certificate]

STATE OF MICHIGAN, } ss:
City of Detroit. }

CITY CLERK'S OFFICE, DETROIT

I, Fred W. Castator, city clerk of the city of Detroit, in said State, do hereby certify that the annexed paper is a true copy of a resolution adopted by the common council, at a session held on the 10th day of January 1939, and approved by the mayor on the 11th day of January 1939, as appears from the journal of said common council remaining in the office of the city of Detroit, aforesaid; that I have compared the same with the original, and the same is a correct transcript therefrom, and of the whole of such original.

In witness whereof I have hereunto set my hand and affixed the corporate seal of said city, at Detroit, this 11th day of January A. D. 1939.

[SEAL]

FRED W. CASTATOR,
City clerk.

NEWARK

CERTIFIED COPY OF A RESOLUTION ADOPTED BY THE BOARD OF COMMISSIONERS

Whereas the Treasury Department of the Federal Government has proposed that the next Congress enact a statute which would attempt to tax future issues of municipal securities; and

Whereas the effect of such a statute might vest in the Federal Government the power to tax outstanding bonds and might open the door to the taxation of municipal revenues; and

Whereas the municipal financing would bear the full impact of such a tax because of the lack of authority or prospect of recoupment by the municipalities: therefore be it

Resolved by the Board of Commissioners of the City of Newark, That its opposition is hereby expressed against the proposed statute to tax municipal securities because the result thereof would be reflected in a higher interest rate requirement in the sale of such securities; and be it further

Resolved, That our Representatives in Congress be, and they are hereby, requested to oppose the statute above mentioned, and the city clerk be and he is hereby instructed to send a copy of this resolution to the United States Senators Smathers and Milton and Senator-elect Barbour, and Congressmen Hartley, Vreeland, and Kean.

M. ELLENSTEIN,
M. P. DUFFY,
PEARCE R. FRANKLIN,
JOS. M. BYRNE, JR.,
The Board of Commissioners of the City of Newark, N. J.

I hereby certify that the foregoing is a true copy of a Resolution adopted by the Board of Commissioners of the City of Newark at a meeting held December 27, 1938.

In testimony whereof I have hereunto set my hand and affixed the seal of the City of Newark this 27th day of December A. D., 1938.

[SEAL]

HARRY S. REICHENSTEIN,
City Clerk of Newark, N. J.

MINNEAPOLIS

RESOLUTION

(By Alderman Bastis)

OPPOSING FEDERAL TAXATION OF MUNICIPAL SECURITIES

Resolved by the City Council of the City of Minneapolis, That the City Council of the City of Minneapolis hereby opposes any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment, guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions and agencies.

Passed December 9, 1938.

ERIC G. HOYER,
President of the Council.

Approved December 12, 1938.

ERIC G. HOYER,
Acting Mayor.

Attest:

CHAS. C. SWANSON,
City Clerk.

CITY OF MINNEAPOLIS,
January 16, 1939.

MR. PAUL V. BETTERS,
Executive Director, the U. S. Conference of Mayors,
Washington, D. C.

DEAR SIR: In reply to your communication of January 14, requesting copy of action of the city council regarding Federal taxation, wish to state that on Decem-

ber 9, 1938, the city council passed a resolution opposing Federal taxation of municipal securities. A copy of this resolution is herewith inclosed.

Very truly yours,

CHAS. C. SWANSON, *City Clerk.*

PORTLAND (OREG.)

RESOLUTION NO. 21556

Be it resolved, That the Council of the City of Portland deems it inadvisable that the Congress place in the hands of any Federal department the power to weaken and destroy the local governmental units of the Nation by taxing their securities and revenues and is, therefore, opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting any Federal taxation of State and municipal revenues other than bonds; and

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Oregon, to the Attorney General of the United States, the Governor and the Attorney General of the State of Oregon, and to the chairmen of the senate and house ways and means committee of the Oregon State Legislature.

Adopted by the council January 19, 1939.

WILL E. GIBSON,
Auditor of the City of Portland.

PORTLAND (OREG.)

JANUARY 16, 1939.

To the Council:

GENTLEMEN: Your commissioner of finance is returning Council Calendar No. 229, being communication from city attorney re hearings scheduled to begin on January 16 before the special Senate committee appointed to study ways and means of ending tax exemption. The adoption of this report would instruct your commissioner to communicate with the Oregon delegation in Congress and the Washington representatives of the various municipal organizations, advising them of the effect of such legislation upon the financial program of the city of Portland.

Your commissioner believes this program to be of sufficient importance for council action. Your commissioner is, therefore, submitting a short report to advise the council of his findings, conclusions and recommendations. To cover the subject of Federal taxation of State, municipal and other political subdivisions as it relates to bonds and salaries of employees completely would require much more time of the council and a more thorough report from your commissioner than would appear necessary at this time. Therefore, your commissioner is setting forth a few pertinent facts that are the definite conclusions reached by him over a long period of contact with the subject through the medium of conferences with national authorities, correspondence with recognized experts and attendance at national meetings of tax specialists, all of whom have given this subject special study and none of whom differ in any major particular from the opinion of your commissioner.

There are two phases of the proposed legislation, each of which should receive separate consideration, namely:

1. Federal taxation of State and municipal securities.
2. Federal income tax on employees of the political subdivisions.

The national organizations that have taken the leading part in bringing to light the inequalities and unfairness of this proposed legislation are the Conference on State Defense, composed of the attorneys general of more than 40 sovereign States, including the State of Oregon, the United States Conference of Mayors, the National Municipal Association, Municipal Finance Officers' Association, National Institute of Municipal Law Officers, and others of equal importance, including many national labor organizations.

For more than 100 years Congress and the United States Supreme Court have protected the States of the Union from Federal encroachment of this character. It has been generally agreed by most students and authorities on this subject, including numerous committees of Congress, based on former opinions of the United States Supreme Court, that the only way municipal securities and revenue can be taxed would be by constitutional amendment. The 150 years' protection

of the sovereignty of the States is threatened seriously if this proposal is enacted into law. Such a dangerous precedent, if granted by Congress, should place the Federal Government in a position to tax even to the extent of destroying the sovereignty of the States.

Surely it should be granted by any fair-minded person that if such a proposal were enacted into law, it should be on a reciprocal basis, giving States and cities the privilege of imposing an income tax on the earnings of Federal securities and also on salaries paid to Federal employees. The States' consent through constitutional amendment guaranteeing this reciprocal privilege to the States, municipalities, and all of their agencies, should be the only method of approaching this matter—surely not by congressional action.

The fallacious idea shared by many uninformed people that this is a method of taxing the rich is upset by the following facts:

It will be obvious that the burden will fall upon the taxpayers of the cities, school districts, public-owned utilities and subdivisions of the States, especially those States like Oregon, where these subdivisions do not have the power to levy an income or intangibles tax and where it is the practice to preempt the city and county revenue and not return any of the tax collected from these sources to the smaller units.

The interest rate on municipal bonds would be increased from one-half percent to 2 percent, which would not be paid by the investors in these securities, but by the real-estate taxpayers who are now burdened almost to the point of confiscation. Municipal issues would be less attractive to investors and the Federal income raised would be more than offset by the additional cost of cities and city taxpayers.

If the Federal Government loads an additional financial burden on municipal property owners, then it would appear just that the local subdivisions should be given a reciprocal privilege of gaining compensating revenue. In support of this statement, your commissioner quotes Vice President John N. Garner, when this subject was before the Sixty-seventh Congress (Congressional Record, vol. 64, p. 712):

"The advocates of this amendment talk about it from an economic standpoint. I can demonstrate, and the estimator for the Treasury Department will bear it out, that for every dollar's worth of taxes you get in the way of taxation by virtue of this amendment the interest paid will be four times that tax. The people pay this in the long run, whether the bonds are issued by the Federal Government, the State government, the county, the school district, the road district, the irrigation district, the drainage district or by whatever other political subdivision. The people pay for it after all. Why do you want to adopt a system by which for every dollar you get into the Treasury of the United States, $4 will have to be paid by the public in the form of added interest?"

One recognized national authority estimates a minimum of $113,000,000 in cost of State and local financing if the proposal prevails. Of this amount, his minimum cost to cities is estimated to be approximately $60,000,000, to school districts, $10,500,000, and to counties, $20,000,000. These are very conservative estimates, for if the law applies to outstanding issues, the city of Portland alone, exclusive of the other tax-levying agencies in Multnomah County, would probably pay an additional $100,000 or more. This authority, by analyzing the tax structures of more than a dozen cities with population in excess of 300,000 and with gross debt ranging from $70,000,000 to over $2,000,000,000, indicates that the increased levy per $1,000 assessed valuation would range from 42 cents to $2.10 per $1,000, depending, of course, upon many factors, each of which was given separate consideration as it applied to the cities studied.

Speaking before the American Statistical Association in Detroit, Dr. Harley L. Lutz, who has been professor of economics at Oberlin College and Stanford University, and professor of Public Finance at Princeton since 1928, noted that the most serious consequences of the taxation of municipal securities would fall upon the cities and would inevitably necessitate an increase in municipal real-estate taxes. In this connection he pointed out that the prevalent notion that the taxation of such securities would hit the wealthy was utterly fallacious. Dr. Lutz pointed out that the investor in the municipal bond, who would have to pay a Federal tax on the interest received would simply pass on the greater part of the tax to the States and cities in the form of increased interest charges, and that these additional costs, especially in the case of States and cities would be paid by the millions of persons with small incomes and small businesses, who now pay the bulk of all taxes for the support of State and local government. He noted that it required an income level of between $55,000 and $65,000 before the individual purchaser begins to gain through the purchase of nontaxable securities and quoted further statistics to show than less that 10 percent on the average of the invest-

ments of estates probated throughout the country over the past 11 years, of a million dollars and over, were invested in State and municipal bonds as compared with an average holding in the same estates of over 55 percent in the capital stocks of corporations. For over 105,000 estates under a million dollars, probated during the same period, the returns indicated that an average of only 3.61 percent of the gross estate was invested in exempt State and municipal bonds.

It would be 40 years before all of the effects of the change could be registered. This would indicate that there is no particular emergency and the matter should be referred to the States in the proper manner.

The States' and local governments' freedom from the domination of such a complete centralization of the tax system would depend entirely upon the sufferance of the Federal Government. This would create an impossible situation in which the present form of Federal Government and local self-government could not be maintained. It will be further agreed that any plan to tax the securities already issued is open to the charge of bad faith. Consideration of such interference with the fiscal powers of municipalities should not be countenanced unless the proper form of constitutional amendment is first submitted to the States.

Consider the far-reaching effect of such legislation on the States, counties, cities, school districts, water districts, drianage and irrigation districts and public-owned utilities such as light, power, water, and recreation; also the injustice to the employes of these units and the already overburdened taxpayers supporting, through an ad valorem tax, many of these governmental functions.

Your commissioner believes that if municipal employes are to be taxed on their salaries, then surely this same should apply to Federal employes of every character. In the event that such should come to pass, then surely municipal employees should not be required to pay on their back salaries to 1926, which is the contention of the United States Treasury Department. This would be a gross injustice and an impossibility. Again such an imposition would reflect on property taxes, imposing an additional burden on a class that cannot carry an additional tax load.

Inasmuch as our city will have reduced the general bonded indebtedness by approximately $17,000,000, or about 34 percent, by the end of 1939, over the amount of such debt in 1932, and our policy is not to incur any additional bonded debt, if the act is not retroactive, we would not be severely affected on that score. The exception would be on district improvement bonds and refunding issues.

In view of the fact that the hearings of the congressional committee start on January 16, your commissioner respectfully submits the attached resolution for the favorable consideration of the council. Your commissioner also recommends memorializing the National Congress and the Oregon State Legislature and advising the Oregon delegation in Congress of our action if favorable to the resolution.

Respectfully submitted.

R. E. RILEY,
Commissioner of Finance.

HOUSTON

JANUARY 25, 1939.

Honorable City Council of the City of Houston:

GENTLEMEN: Herewith I submit a resolution entitled:

"A resolution declaring the sense of the City Council of the City of Houston with respect to pending legislation before the Congress of the United States proposing to tax municipal bonds and municipal salaries; directing the city secretary to transmit a copy of this resolution to each United States Senator from Texas, to the Congressman from Harris County, and to the United States conference of mayors, and declaring an emergency."

There exists a public emergency requiring that this resolution be passed finally on the date of its introduction, and I hereby request that you pass same accordingly, if it meets with your approval.

Very truly yours,

O. F. HOLCOMBE,
Mayor of the City of Houston.

A resolution declaring the sense of the City Council of the City of Houston with respect to pending legislation before the Congress of the United States proposing to tax municipal bonds and municipal salaries; directing the city secretary to transmit a copy of this resolution to each United States Senator from Texas, to the Congressman from Harris County, and to the United States Conference of Mayors, and declaring an emergency

Whereas the City Council of the City of Houston is informed that certain legislation is now pending before the Congress of the United States in which it is proposed to tax municipal bonds and municipal salaries; and

Whereas the City Council of the City of Houston is of the considered opinion that such legislation is an unwarranted invasion of the sovereignty of the States and constitutes an interference with local self-government under the guise of which unscrupulous powers may force local authorities to do and perform acts contrary to the public good; and

Whereas the city council is of the further opinion that such proposed legislation affords a precedent whereby the Federal Government may extend its sphere of influence and wield its powers in such a manner as was never contemplated by the founders of this Government and that such legislation is contrary to the true spirit of a liberal form of government: Now, therefore, be it

Resolved by the city council of the city of Houston:

SECTION 1. That the legislation now pending before the Congress of the United States of America proposing to tax municipal bonds and salaries of municipal officials should not be enacted into law for the reasons set forth in the preamble of this resolution.

SEC. 2. The city secretary is hereby directed to prepare four certified copies of this resolution and transmit one to each of the Senators of the State of Texas, one to the Member of Congress from Harris County, and one to the United States Conference of Mayors.

SEC. 3. There exists a public emergency requiring that this resolution be passed finally on the date of its introduction, and the mayor having in writing declared the existence of such emergency and requested such passage, this resolution shall be passed finally on the date of its introduction, this the 25th day of January A. D. 1939, and shall take effect immediately upon its passage and approval by the mayor.

Passed this the 25th day of January A. D. 1939.

Approved this the 25th day of January A. D. 1939.

O. F. HOLCOMBE,
Mayor of the City of Houston.

Approved.

WILL SEARS,
Assistant City Attorney.

THE STATE OF TEXAS,
County of Harris, city of Houston:

I, M. H. Westerman, the duly appointed, qualified, and acting assistant city secretary of the city of Houston, Tex., do hereby certify that the foregoing is a true and correct copy of a resolution passed by the City Council of the City of Houston, on the 25th day of January A. D. 1939, as reflected by the official records of the city of Houston, kept by me in my official capacity.

To certify which, witness my hand and the seal of the city of Houston, this 25th day of January A. D. 1939.

[SEAL]

M. H. WESTERMAN,
Assistant City Secretary of the city of Houston, Tex.

ST. PAUL

OFFICE OF THE CITY CLERK

[Council resolution—General form]

PRESENTED BY MAYOR W. H. FALLON

Whereas there is now pending before the Congress of the United States a proposal wherein it is sought to have legislation adopted by means of which income taxes will be levied upon the income derived from interest on municipal bonds and also from the levy of a Federal income tax upon salaries of State and municipal employees; and

Whereas the municipalities and especially the larger municipalities of this country are now admittedly staggering under the excess burden of taxation caused by the large number of persons on relief rolls, and such municipalities are finding it increasingly difficult to obtain the money necessary for the relief of such poor persons; and

Whereas the levy of a Federal income tax upon income derived from interest on municipal bonds would necessarily increase the carrying charges of such bonds and would increase the interest rate to be paid by such municipalities; and

Whereas the salaries of the employes of the city of St. Paul are in the main based upon a cost-of-living wage ordinance wherein salaries are increased or decreased depending upon the current cost of living, and the levy of a Federal income tax on such salaries would undoubtedly bring about a concerted effort on the part of such employees to have their salaries increased to compensate for such Federal taxes and thereby further increase the cost of such municipal government; and

Whereas the proposal to afford the right of the various States to levy a State income tax upon the salaries of Federal employees located within the boundaries of each State would in no way assist the financial condition of the city of St. Paul for the reason that the State income tax already adopted by the Legislature of the State of Minnesota has caused a heavy burden upon the taxpayers of such city, with no appreciable decrease in the other taxes payable for the carrying on of such municipal government, and the income tax law of the State of Minnesota is such that the city of St. Paul will not benefit by any increase in the income attributable to that fund; and

Whereas, in the opinion of the City Council of the City of St. Paul the adoption of such legislation levying such Federal income tax would be improper, unwise and unfair, and would cause an additional burden on the finances of said city: Therefore be it

Resolved by the City Council of the City of St. Paul, That it opposes the adoption of such legislation and urges the Senators and Representatives in Congress, from the State of Minnesota, to oppose the adoption of such legislation; be it further

Resolved, That copies of this resolution be forwarded to the President of the United States, each Senator and Representative from Minnesota in Congress of the United States, to the Conference on State Defense at 111 Eighth Avenue, New York City, and to the Conference of Mayors, in Washington, D. C.

Adopted by the council January 19, 1939.

Approved January 19, 1939.

W. H. FALLON, *Mayor.*

AKRON

(Offered by Sanderson)

Resolution No. 347–1938, requesting the Congress of the United States to enact legislation prohibiting retroactive taxation of State and municipal employees; to prevent Federal taxation of outstanding securities of States and municipalities and their agencies; and to prevent Federal taxation of the revenues or income of States and municipalities and their agencies.

Whereas during the course of a century, the Constitution of the United States has been interpreted to forbid the taxation by the Federal Government of the employees of the States, and of State instrumentalities, and to forbid the taxation of State and municipal bonds; and

Whereas the Department of Justice, under date of June 24, 1938, submitted a report on "The Immunity Rule and the Sixteenth Amendment" to the Treasury Department, which report concludes that the Federal Government has power to tax all State and municipal bonds, both those outstanding and future issues, and has also the power to tax the salaries of all officers and employees of the States and municipal governments; and

Whereas said report further concludes that the States have no such power to levy a tax upon Federal bonds and Federal salaries; and

Whereas municipal and State employees, by reason of said report, are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926; and

Whereas bonds have been sold on the representation of State and municipal officers, and under existing regulations of the Treasury Department, that they were exempt from Federal taxation; and

Whereas the enforcement by the Federal Government of the conclusions contained in said report would be an injustice upon State and municipal employees and would seriously and injuriously affect the financial standing of the city of Akron and its ability to issue future bonds; and

Whereas this council has already expressed its sentiment by resolution in favor of the taxation of salaries, accruing and to be earned in the future, upon the same

basis as income taxes now are, and may hereafter be levied upon the earnings of other individuals not engaged in public service, and the members of this council are actively opposed to the present policy of granting special privileges and immunities from income tax to public officials generally: Now therefore,

Be it resolved by the Council of the city of Akron:

SECTION 1. That this council respectfully petitions the Congress of the United States at its next session to pass legislation prohibiting the retroactive taxation of State and municipal employees; the prevention of Federal taxation of outstanding securities of States and municipalities and of State and municipal agencies; and the prevention of Federal taxation of the revenues or income of States and municipalities and of State and municipal agencies, and also to enact legislation insuring the collection of income taxes upon future earnings from all municipal, county, State and Federal employees on the same basis as levied upon the earnings of other individuals generally.

SEC. 2. That a copy of this resolution be forwarded by the clerk of this council to the Clerk of the United States Senate, Senate Office Building, Washington, D. C.; to the Clerk of the United States House of Representatives, House Office Building, Washington, D. C.; to Hon. Vic Donahey, United States Senator, Washington, D. C.; to Hon Robert J. Bulkley, United States Senator, Washington, D. C.; to Hon. Dow W. Harter, Member of the House of Representatives of the Fourteenth Congressional District, Washington, D. C.; and to Conference on State Defense, 111 Eighth Avenue, New York, N. Y.

(Passed September 6, 1938.)

ROBERT M. SANDERSON,
President of the Council.

J. M. BAUMAN,
Clerk of Council.

———— ————, *Mayor.*

I hereby certify that Resolution No. 347–1938 was not returned by the mayor signed or vetoed with 10 days, nor was he prevented from so doing by the adjournment of council.

———— ————, *Clerk of Council.*

NORFOLK

A RESOLUTION OF THE COUNCIL OF THE CITY OF NORFOLK REGARDING FEDERAL TAXATION OF MUNICIPAL REVENUES, BONDS, AND SALARIES

Whereas the Council of the City of Norfolk is advised that certain Federal agencies have interpreted the decision of the United States Supreme Court in the recent case of *Helvering* v. *Gearhardt* as empowering the Federal Government to tax all State and municipal employees, State and municipal revenues and securities, as well as the revenues of State and municipal agencies; and

Whereas it is the judgment of the council that such taxation will be detrimental to the interests of city employees and seriously handicap city finances, and it desires to record its opposition thereto: Now, therefore, be it

Resolved by the Council of the City of Norfolk:

SECTION 1. That if it is the intention of the Federal Government to tax State and municipal officers and employees, suitable congressional legislation should be passed limiting such taxation to future salaries.

SEC. 2. That there should be no taxation of State and municipal securities by the Federal Government unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities and prohibiting Federal taxation of State and municipal revenues or revenues of State and municipal agencies.

SEC. 3. That the city clerk be, and he is hereby, authorized and instructed to forward certified copies of this resolution to the chairman of the Senate Finance Committee, the chairman of the House Ways and Means Committee, and to the Representatives in Congress of the State of Virginia.

Adopted by the Council of the City of Norfolk January 10, 1939.

Teste:

[SEAL]

JNO. D. CORBELL, *City Clerk.*

DES MOINES

DES MOINES, IOWA, *December 19, 1938.*

Roll call No. 3439

Be it resolved by the City Council of the City of Des Moines:

1. That this council be recorded as opposing the collection by the Federal Government of income taxes for any past period for either State, county, or municipal officials or employees, for the reason that we believe it is un-American to enforce any provision of law which no one contemplated for any past period of time.

2. That the opposition of this council be also recorded to any attempt by the Federal Government to tax all State and municipal bonds, thus increasing interest costs up to 25 percent over what they are now, for the reason that this would tend to destroy all hope for the betterment of the conditions of the taxpayer. Should bond exemptions be ended both as to State and Federal bonds it should not be done at the expense of the States and municipalities and their employees to the sole advantage of the Federal Government. There should be true reciprocity in any movement to tax State and Federal bonds.

3. That opposition to taxation of State and Federal bonds is hereby recorded by this council for the further reason that this city has both police and fire pension funds that would be jeopardized by the taxation of outstanding public securities.

4. That the opposition of this council be also recorded against the taxation by the Federal Government of income of municipalities or other agencies or utilities to pay an actual corporate income tax upon their revenue receipts for the reason that the same would increase the burden of taxation on its already over-burdened citizens.

5. That in our opinion the taxation of State and municipal securities should never be permitted until such time as the States have the right to tax Federal securities. As a governmental unit of the State, in recognizing the sovereign right of the State, we contend that the taxation of the income thereof would be an encroachment upon the sovereign right.

6. That this council be recorded as favoring an act of Congress at its next session to prevent the retroactive application of any Federal tax upon employees of States and their municipalities.

7. That the opposition of this council be recorded against any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment, guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions, and agencies.

8. And that finally we urge upon Congress to preserve the balance of power between the Central Government, on the one hand, and the States and municipalities on the other.

Moved by Conkling to adopt.

Form approved.

SAM OREBAUGH, *Assistant City Solicitor.*

I, Rex Ramsay, city clerk of said city, hereby certify that at a meeting of the city council of said city of Des Moines, held on the above date, among other proceedings the above was adopted.

In witness whereof, I have hereunto set my hand and affixed my official seal the day and year first above written.

Approved December 19, 1938.

MARK L. CONKLING, *Mayor.*
REX RAMSAY, *City Clerk.*

MIAMI

RESOLUTION NO. 13643

A resolution opposing any legislation by Congress of direct or indirect taxing incomes from municipal bonds; providing for the sending of certified copies of this resolution to the Florida Representatives—C. O. Andrews, Claude A. Pepper, and J. Mark Wilcox

Whereas it has been brought to the attention of the city commission that Congress is considering legislation taxing the income from municipal bonds, and

Whereas if such proposed legislation requires that income from municipal bonds be included in an individual's income for the purpose of determining surtax rates applicable to his taxable income, it would undoubtedly result in a substantial increase in the local tax burdens as it would be necessary for cities and political subdivisions to pay interest at a higher rate on bonds thereafter issued by them: Now, therefore, be it

Resolved by the Commission of the City of Miami:

SECTION 1. That the City Commission of the City of Miami hereby goes on record as opposing the enactment by Congress of legislation directly or indirectly taxing the income from municipal bonds as the same would undoubtedly result in substantial tax increase in local tax burdens and it would be necessary for cities and political subdivisions to pay interest at higher rates on bonds issued.

SEC. 2. That the city of Miami is now engaged in refunding of its bonded indebtedness at a reduced rate of interest and feels that such legislation directly or indirectly taxing the income from municipal bonds would be detrimental to its refunding program.

SEC. 3. That the city clerk of the city of Miami be, and he is hereby, authorized and instructed to send certified copies of this resolution to Senators C. O. Andrews, Claude Pepper, and Congressman J. Mark Wilcox.

Passed and adopted this 9th day of December A. D. 1937.

LONG BEACH

RESOLUTION

Whereas concerted efforts are now being made to subject to Federal taxation the income from municipal bonds and the salaries of municipal employees, and to give such taxation retroactive effect; and

Whereas the taxation of income from municipal bonds would inevitably result in increasing the cost of local government and, insofar as retroactive, would work a serious injustice to persons who paid a higher price for such bonds, relying upon their exemption from taxation, than they otherwise would have paid; and

Whereas the retroactive taxation of the income of municipal employees would be financially ruinous and unfair to those employees and injurious to the communities in which they reside: Now, therefore, be it

Resolved, That the City Council of the City of Long Beach, Calif.—

(1) Condemn as unfair, oppressive, and un-American the imposition of retroactive taxes upon the income from municipal bonds and municipal salaries;

(2) Condemn the unwarranted extension of Federal power and the weakening of local government through the taxation of income from municipal bonds to be issued in the future;

(3) Urge that if equitable and nonretroactive taxation of the income from municipal salaries hereafter be contemplated, such taxation be authorized only on the condition that the State be afforded the reciprocal right to tax income from Federal salaries;

(4) Are convinced that the radical change in relationship between local and Federal governments that is inherent in current efforts to tax municipal securities and salaries should be accomplished only by sanction of the people as a whole, expressed through well-considered amendment of the Constitution, and not by judicial lawmaking; be it further

Resolved, That we hereby urge all candidates for election to the Congress to carefully consider the views herein expressed, and to lend their constant support to all proper legislative means for carrying them into effect.

SPOKANE

RESOLUTION

Resolved, by the Council of the City of Spokane, Wash., That we go on record as condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our Representative in Congress, urging them to do all in their power to carry out our wishes.

Adopted by the city council, November 7, 1938.

A. A. BROWN, *City Clerk.*

GLENDALE

RESOLUTION

Whereas concerted efforts are now being made to subject to Federal taxation the income from municipal bonds and the salaries of municipal employees, and to give such taxation retroactive effect; and

Whereas the taxation of income from municipal bonds would inevitably result in increasing the cost of local government and, insofar as retroactive, would work a serious injustice to persons who paid a higher price for such bonds, relying upon their exemption from taxation than they otherwise would have paid; and

Whereas the retroactive taxation of the income of municipal employees would be financially ruinous and unfair to those employees and injurious to the communities in which they reside: Now, therefore, be it

Resolved, That the council of the city of Glendale:

(1) Condemn as unfair, oppressive, and un-American the imposition of retroactive taxes upon the income from municipal bonds and municipal salaries;

(2) Condemn the unwarranted extension of Federal power and the weakening of local government through the taxation of income from municipal bonds to be issued in the future;

(3) Urge that if equitable and nonretroactive taxation of the income from municipal salaries hereafter be contemplated, such taxation be authorized only on the condition that the State be afforded the reciprocal right to tax income from Federal salaries;

(4) Are convinced that the radical change in relationship between local and Federal Government that is inherent in current efforts to tax municipal securities and salaries should be accomplished only by sanction of the people as a whole, expressed through well-considered amendment of the Constitution, and not by judicial lawmaking; be it further

Resolved, That we hereby urge all candidates for election to the Congress to carefully consider the views herein expressed, and to lend their constant support to all proper legislative means for carrying them into effect.

I, G. E. Chapman, city clerk of the city of Glendale, do hereby certify that the foregoing is a true and correct copy of resolution adopted by the council of the city of Glendale, Calif., on the 27th day of October 1938.

[SEAL] G. E. CHAPMAN, *City Clerk.*

MOBILE

RESOLUTION

Whereas an effort is being made to induce the Congress of the United States to pass legislation taxing the income derived from securities issued by sovereign States and their political subdivisions (H. R. 1791, S. 554); and

Whereas outstanding economists have estimated that the levying of a Federal tax on the income from municipal bonds will result in municipalities having to pay an increased rate of interest on such bonds equal to approximately twice as much as the Federal tax, thereby causing the local taxing powers to lose approximately $2 every time the Federal taxing power gains $1 in consequence of such proposed legislation; and

Whereas cities generally do not have the power to impose a municipal income tax on securities issued by the United States Government, even should Congress grant such power, due to prohibitive State laws; and

Whereas it is believed, as stated in many United States Supreme Court decisions, that the power to tax is the power to destroy, and that the giving of such power to the Federal Government would be a step toward the establishment of a totalitarian state and would enable the Central Government to use coercion in forcing through its policies by the weapon of driving State and municipal securities from the market through heavy taxation; Now, therefore, be it

Resolved by the Board of Commissioners of the city of Mobile as follows:

SECTION 1. Each Senator and Member of the House of Representatives of the United States Congress is hereby requested to use every effort to prevent the passage of the proposed legislation.

SEC. 2. The city clerk is hereby directed to send a certified copy of this resolution to each such Senator and Representative and to the following-named additional persons: Hon. Austin J. Tobin, secretary, Conference on State Defense, 111 Eighth Avenue, New York City; Hon. John A. McIntire, executive director, National Institute of Municipal Law Officers, 730 Jackson Place NW., Washington, D. C.; Hon. Frank M. Dixon, Governor of Alabama, Montgomery, Ala.; Hon. Hugh D. Merrill, speaker of the house of representatives, Montgomery, Ala.; Hon. Paul V. Betters, executive director, United States Conference of Mayors, 730 Jackson Place NW., Washington, D. C.; Hon. Ed Reid, executive secretary, Alabama League of Municipalities, Exchange Hotel, Montgomery, Ala.; Hon. A. A. Carmichael, Lieutenant Governor, State of Alabama, Montgomery, Ala.

S. H. HENDRIX, *City Clerk.*

DULUTH

OFFICE OF CITY CLERK,
Duluth, Minn.

(By Commissioner Williams)

Resolved, That the city council of the city of Duluth hereby respectfully petitions the Congress of the United States of America to oppose and to defeat any Federal legislation designed or intended to place a tax on municipal salaries and bond interest; and be it further

Resolved, That if such petition be denied, and the Congress of the United States does enact a law imposing a tax on municipal salaries and bond interest, that in such case the Congress shall at the same time confer authority and power upon each of the several States of the United States to impose a State tax on Federal salaries and bond interest and upon real estate owned by the United States of America and situated in the several States; and be it further

Resolved, That the city clerk of the city of Duluth is hereby authorized and directed to mail a certified copy of this resolution to each Senator and Representative representing the State of Minnesota in the Senate and House of Representatives of the United States, to the Conference of State Defense, 111 Eighth Avenue, New York City, N. Y., and to C. C. Ludwig, executive secretary of the League of Minnesota Municipalities, Minneapolis, Minn.

Commissioner Williams moved the adoption of the resolution and it was declared adopted upon the following vote:

Yeas—Commissioners Bodin, Culbertson, Merritt, Williams, and Mayor Berghult—5.

Nays—None.

Adopted December 19, 1938.

Approved December 19, 1938.

I, C. D. Jeronimus, city clerk of the city of Duluth, in the State of Minnesota, do hereby certify that I have compared the annexed copy of resolution passed by the city council of the city of Duluth, on the 19th day of December 1938, with the original document and record thereof on file and of record in my office, and in my custody as city clerk of said city, and that the same is a true and correct copy thereof, and the whole thereof, and a true and correct transcript therefrom.

In witness whereof, I have hereunto set my hand and affixed the corporate seal of said city of Duluth, this 23d day of January 1939.

[SEAL]

C. D. JERONIMUS, *City Clerk,*
City of Duluth, Minn.

MACON

A RESOLUTION OF THE MAYOR AND COUNCIL OF THE CITY OF MACON, GA.

Whereas it has come to the attention of this governing body that a special Senate committee of the Congress of the United States is now giving attention to a proposal that municipal bonds and salaries of municipal employees be subjected to a Federal tax; and

Whereas it is our opinion that such taxes will, through increased salaries to employees and the necessity of an increased interest rate on future issues of bonds, eventually be a burden and charge upon the municipality; and

Whereas the financial condition of municipalities throughout the country has brought about a condition where survival itself is largely dependent upon strict economy in administrative expense and reduction, through refinancing, of interest charges on bonded indebtednesses; Now, therefore, be it

Resolved by the mayor and council of the city of Macon and it is so resolved, That in the interest of all municipalities the proposed tax measure should be rejected and that this expression of opinion be communicated to the United States Conference of Mayors for transmission in turn to the proper Federal authorities.

Passed in open council and at a regular meeting, this 17th day of January 1939.

[SEAL] VIOLA R. NAPIER, *City Clerk.*

Approved this January 18, 1939.

———— ————, *Mayor.*

PASADENA

RESOLUTION NO. 6670

A resolution of the Board of Directors of the City of Pasadena urging Representatives in Congress to oppose retroactive taxes upon income from municipal bonds and salaries, and opposing extension of Federal power relative thereto unless local power relative thereto may be reciprocal

Whereas concerted efforts are now being made to subject to Federal taxation the income from municipal bonds and the salaries of municipal employees, and to give such taxation retroactive effect; and

Whereas the taxation of income from municipal bonds would inevitably result in increasing the cost of local government and, insofar as retroactive, would work a serious injustice to persons who paid a higher price for such bonds, relying upon their exemption from taxation than they otherwise would have paid; and

Whereas the retroactive taxation of the income of municipal employees would be financially ruinous and unfair to those employees and injurious to the communities in which they reside: Now, therefore, be it

Resolved by the Board of Directors of the City of Pasadena:

(1) Condemn as unfair, oppressive, and un-American the imposition of retroactive taxes upon the income from municipal bonds and municipal salaries:

(2) Condemn the unwarranted extension of Federal power and the weakening of local government through the taxation of income from municipal bonds to be issued in the future;

(3) Urge that if equitable and nonretroactive taxation of the income from municipal salaries hereafter be contemplated, such taxation be authorized only on the condition that the State be afforded the reciprocal right to tax income from Federal salaries and from Federal securities;

(4) Are convinced that the radical change in relationship between local and Federal Government that is inherent in current efforts to tax municipal securities and salaries should be accomplished only by sanction of the people as a whole, expressed through well-considered amendment of the constitution, and not by judicial lawmaking; be it further

Resolved, That we hereby urge our Representatives and Senators in Congress to carefully consider the views herein expressed, and to lend their constant support to all proper legislative means for carrying them into effect, and the city clerk is hereby instructed to transmit immediately a copy of this resolution to United States Senator Hiram W. Johnson, Senator-elect Sheridan Downey, and Representative in Congress, J. C. W. Hinshaw.

The city clerk shall certify to the adoption of this resolution.

I hereby certify that the foregoing resolution was adopted by the Board of Directors of the city of Pasadena at its meeting held November 29, 1938, by the following vote: Ayes: Directors Brenner, Dawson, Hamill, Nay, Riccardi, Stewart, Wopschall. Noes: None.

BESSIE CHAMBERLAIN, *City Clerk.*

Signed and approved this 29th day of November 1938.

EDWARD O. NAY,
Chairman of the Board of Directors of the City of Pasadena.

DURHAM

RESOLUTION

Be it resolved by the city council of the city of Durham, That we go on record as condemning any attempt on the part of the Federal Government to levy the following taxes:

1. A tax on the revenue of the States or their municipalities.
2. A tax on municipal bonds or the interest therefrom.
3. To make retroactive a tax on the salaries of State and local governmental employees; be it further

Resolved, That copies of this resolution be sent to our United States Senators and our Representative in Congress urging them to do all in their power to carry out our wishes.

I, C. B. Alston, city clerk of the city of Durham, N. C., do hereby certify that foregoing resolution was unanimously adopted by the city council of the city of Durham, N. C., at its meeting held December 19, 1938, as is recorded in minute book (S), page 321.

[SEAL] C. B. ALSTON, *City Clerk.*

MCKEESPORT

CITY COUNCIL RESOLUTION NO. 4006

A resolution condemning any attempt on the part of the "Federal" Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds or the salaries of state and local governmental employees—unless and until the consent of the State is first obtained through a proper constitutional amendment; * * *

Resolved, by the city of McKeesport, in Council Assembled, That we, the City Council of the City of McKeesport, Pa., go on record as condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds or the salaries of State and local governmental employees, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and our Representative in Congress urging them to do all in their power to carry out our wishes.

Passed finally in council this 12th day of December A. D. 1938.

GEO. H. LYSLE,
Mayor and President of Council.

Attest:

JOHN F. ALDERIN,
Clerk of Council.

I hereby certify that the foregoing is a true, correct copy of a resolution of the city of McKeesport, Pa., and that the same went into effect the 12th day of December 1938.

Attest:

[SEAL] JOHN F. ALDERIN, *City Clerk.*

CLEVELAND HEIGHTS

TUESDAY EVENING, *January 3, 1939.*

The Council of the City of Cleveland Heights, Ohio, met in regular session on the above date. Mayor Frank C. Cain presiding.

Councilmen present: Brand, Cain, Dunlap, Eggers, Hildebran, Ruedy.

Councilmen absent: Denison.

The council proceeded to the regular order of business.

Mayor Cain introduced the following resolution:

Whereas the Council of the City of Cleveland Heights, Ohio, has been informed of the proposed taxation of State and municipal securities by the Federal Government; and

Whereas such taxation would result in increased interest rates on all such securities issued by this city; and

Whereas such increased interest cost would add to the burden of the taxpayers of this city; Now, therefore, be it

Resolved, That the Council of the City of Cleveland Heights deems it ill-advised to place in the hands of the Federal Government the power to weaken and cripple the local government units of the Nation by taxing their securities; and, be it further

Resolved, That this council is unalterably opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our representatives in Congress, urging them to do all in their power to defeat this proposed legislation.

Councilman Eggers seconded this resolution.

Moved by Councilman Dunlap, seconded by Councilman Ruedy, that the rule requiring resolutions and ordinances to be read on two different dates be suspended and that the foregoing resolution be placed upon its final passage.

Roll call: Ayes—Brand, Cain, Dunlap, Eggers, Hildebran, Ruedy, nays—None. Motion carried.

Moved by Councilman Brand, seconded by Councilman Dunlap, that the foregoing resolution be passed as read.

Roll call: Ayes—Brand, Cain, Dunlap, Eggers, Hildebran, Ruedy, nays—None. Motion carried. Resolution adopted.

There being no further business the meeting adjourned to meet on Monday evening, January 16, 1939, at 8 p. m.

FRANK C. CAIN,
Mayor, President of the Council.
H. M. KIMPEL,
Clerk of the Council.

CEDAR RAPIDS

Whereas it has come to the attention of the City Council of the City of Cedar Rapids, Iowa, that a special Senate committee now in session is giving attention to a proposal of the Federal Government that municipal bonds and the salaries of municipal employees be taxed; and

Whereas an investigation of this matter shows that it is proposed to enact legislation under the sixteenth amendment of the Constitution of the United States under and by virtue of which the Federal Government would acquire authority to tax municipal bonds and the salaries of municipal employees; and

Whereas it has further been found that the Treasury Department of the United States has interpreted a late Supreme Court decision in such a manner that it now claims the right to tax salaries of municipal employees for a period of 12 years last past; and

Whereas such proposed legislation would work a severe hardship on the city of Cedar Rapids, Iowa, would increase the tax burden of taxpayers of the city of Cedar Rapids far in excess of the benefits to be derived by the Federal Government in enforcing and inflicting such proposed taxes; and

Whereas the city council has further been advised that the thought has been expressed that should the Federal Government tax municipal bonds the State of Iowa would be given a reciprocal right to tax Federal bonds the same provisions to prevail in reference to salaries of municipal officers and the salaries of Federal officers residing with the States; and

Whereas upon investigation it has been found that this proposed reciprocal right would be of no benefit to the city of Cedar Rapids whatever in that any revenues derived by the State from the taxation of said bonds and said salaries would be paid into the treasury of the State of Iowa and under the legislation of the State of Iowa there is no method or manner under which the said fund could be paid to the city of Cedar Rapids commensurate with its proportionate share of taxes paid by the city on its municipal bonds or taxes paid on salaries on its municipal employees; and

Whereas it is further the opinion of the city council that the taxation by the Federal Government of municipal and/or State bonds is unconstitutional unless the consent of the State is first obtained: Now, therefore, be it

Resolved by the City Council of the City of Cedar Rapids, Iowa, That said city is opposed to the proposed legislation which would tax municipal bonds and salaries of municipal officers; be it further

Resolved, That a copy of this resolution be forwarded to the United States Senators from the State of Iowa and to the United States Representative from this district to the end that these representatives of the State of Iowa may have the viewpoint of the city council of the city of Cedar Rapids, Iowa, in this matter.

Dated January 16, 1939.

FRANK K. HAHN, *Mayor.*

Attest:

L. J. STOREY, *City Council.*

SIOUX CITY

RESOLUTION NO. Q-2134

Be it resolved by the City Council of the City of Sioux City, Iowa:

PARAGRAPH 1. That this council be recorded as opposing the collection by the Federal Government of income taxes for any past period upon the salaries of either State, county, or municipal officials or employees for the reason that we believe that it is un-American to enforce any provision of law which was not contemplated at the time of its enactment and which would in effect be retroactive.

PAR. 2. That this council be recorded as not opposing the levy and collection of taxes upon the future income of any State, county, or municipal official or employee providing the incomes of Federal officials and employees are taxed likewise in the same manner.

PAR. 3. That the opposition of this council be also recorded to any attempt by the Federal Government to tax all State and municipal bonds, thus increasing interest costs up to 25 percent over what they now are, for the reason that this would tend to destroy all hope for the betterment of the conditions for the taxpayer, unless the reciprocal right to tax Federal securities is granted to the respective States for the reason that should bond exemptions be ended as to State, county, and municipal bonds, it should not be done at the expense of the States and municipalities and their employees to the sole advantage of the Federal Government. There should be true reciprocity in any movement to tax State and Federal bonds.

PAR. 4. That opposition to taxation of State and Federal bonds is hereby recorded by this council for the further reason that this city has both police and fire pension funds that would be jeopardized by the taxation of outstanding public securities.

PAR. 5. That the opposition of this council be also recorded against the taxation by the Federal Government of income of municipalities or other agencies or utilities to pay an actual corporate income tax upon their revenue receipts for the reason that the same would increase the burden of taxation on its already overburdened citizens.

PAR. 6. That in our opinion the taxation of State and municipal securities should never be permitted until such time as the States have the right to tax Federal securities. As a governmental unit of the State, in recognizing the sovereign right of the State, we contend that the taxation of the income thereof would be an encroachment upon the sovereign right.

PAR. 7. That this council be recorded as favoring an act of Congress at its next session to prevent the retroactive application of any Federal tax upon employees of States and their municipalities.

PAR. 8. That the opposition of this council be recorded against any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment, guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions, and agencies.

PAR. 9. And that finally we urge upon Congress to preserve the balance of power between the Central Government, on the one hand, and the States and municiaplities, on the other.

D. S. LEWIS, *Acting Mayor.*

Approved January 27, 1939.

Attest:

[SEAL] ————————, *City Clerk.*

DAVENPORT

Whereas through articles appearing in the public press and through notices received from various organizations composed of State and municipal officials, the attention of the city council of the city of Davenport, Iowa, has been called to the fact that certain departments of the Federal Government propose that Congress attempt to levy and assess taxes on bonds and other securities issued by State and municipal governments and on the incomes of State and municipal officers and employees, including incomes of such officers and employees for several years last past as well as in the future; and

Whereas it is the sense of this city council that such action by Congress would be unjust, un-American, illegal, and contrary to the American ideals and theories of Federal and State Government and would constitute the entering wedge for the ultimate break-down of limitations now existing for the protection of the sovereignty of the several States and their political subdivisions, all to the positive detriment and final destruction of our present system of American Government, and of the balance of power between the Federal Government and the several States; Now, therefore, be it

Resolved by the City Council of the City of Davenport, Iowa, That it hereby be made a matter of public record that this city council is unalterably opposed:

1. To any attempt by the Federal Government to levy or assess taxes on the incomes of State, county and municipal officers and employees, whether future or past incomes, such action being regarded as unconstitutional, unjust, and un-American, especially where a corresponding right to tax the incomes of Federal officers and employees is denied the several States and their political subdivisions;

2. To any attempt by the Federal Government to tax the bonds and other securities issued or to be issued by the several States and their political subdivisions while denying to said States and their political subdivisions a corresponding right to tax bonds and securities issued or to be issued by the Federal Government, for the reason that such action would result in a tremendously increased interest cost to the several States and their political subdivisions as well as in a reduction in the market value of such securities, thereby causing and creating a greatly increased burden on the citizens and taxpayers of the several States and their political subdivisions and seriously affecting their credit and financial standing and stability;

3. To any attempt by the Federal Government to levy or assess a tax on the income of municipalities or of municipal agencies of any kind, for the reason that to do so would merely increase the burden of the taxpayer and of the user or consumer of the services and products of such agencies, and for the further reason that such action would merely be to the sole advantage of the Federal Government without any benefit to the States, their political subdivisions and citizens and taxpayers;

4. To any action by the Federal Government which would tend to break down or in any way lessen or diminish the safeguards of our present system for the protection and preservation of sovereign powers as between the Federal Government and the several States, for the reason that to do so would result in the concentration and centralization of great powers in the Federal Government which is far removed from and less responsive to most of its citizens instead of the retention of localization of government so far as possible, and thereby destroying the American system of government and the balance of power between the Federal Government and the several States which has proven historically sound and which has contributed so much to the happiness and prosperity and welfare of our country and its citizens;

5. To any proposed reciprocal arrangement whereby the Federal Government and the several States may tax the securities of each other or the incomes of the officers and employees of each other, for the reason that the power to tax is the power to destroy and a reciprocal power to tax even by constitutional amendment could and eventually probably would lead to the ultimate detriment and even destruction of the credit and financial standing and stability of each with chaos, uncertainty, and disorder as the inevitable result.

Resolved further, That the Congress of the United States be urged to reject any and all proposals which might or would tend to or in any way bring about the break-down of the present existing limitations on the sovereignty and powers of the Federal Government and the several States and that Congress take such affirmative steps as may be necessary to preserve and protect the balance of power now existing between the Federal Government and the several States to the end that the present system of American Government as we know and understand it may not be injured, changed, or destroyed.

Resolved further, That the clerk be, and he is hereby, directed to send a copy of these resolutions to United States Senator Clyde L. Herring and United States Senator Guy Gillette and to Congressman William Jacobsen.

Passed and approved this 18th day of January 1939.

Attest:

(Signed) JOHN H. JOHENS, *Mayor.*
(Signed) F. A. HASS, *City Clerk.*

TOWN OF IRVINGTON

BOARD OF COMMISSIONERS

Whereas the Treasury Department of the Federal Government has proposed that the next Congress enact a statute which would attempt to tax future issues of municipal securities; and

Whereas the effect of such a statute might vest in the Federal Government the power to tax outstanding bonds and might open the door to the taxation of municipal revenues; and

Whereas the municipal financing would bear the full impact of such a tax because of the lack of authority or prospect of recoupment by the municipalities: Therefore be it

Resolved by the Board of Commissioners of the Town of Irvington, That its opposition is hereby expressed against the proposed statute to tax municipal securities because the result thereof would be reflected in a higher interest-rate requirement in the sale of such securities; and be it further

Resolved, That our representatives in Congress be and they are hereby requested to oppose the statute above mentioned, and the town clerk be and he is hereby instructed to send a copy of this resolution to the United States Senators Smathers and Barbour, and Congressmen Hartley, Vreeland, and Kean.

Approved.

CHESTER

RESOLUTION

Expressing the opposition of city council to the Federal Government taxing States and municipalities and their officials and employees.

The Council of the City of Chester does ordain—

That the Council of the City of Chester hereby and now desires to go on record as being opposed to the Federal Government taxing bonds and incomes, either of them, of States and municipalities and salaries of public officials and employees neither in the future or retroactively, for the following reasons:

1. Because it would actually establish the power of the Federal Government to compel the States and their agencies to pay an income tax upon their revenues.
2. Because it denies corresponding power in the States to tax the Federal Government except by grace of Federal permission which could be repealed by any subsequent Congress.
3. Because it would establish the power of any subsequent Congress to tax already issued securities of the States and their agencies, although they were sold and paid for at a higher price because of exemption.
4. Because it would increase the cost of State and local government and so add to the burdens of the local taxpayers.
5. Because it would foster overcontribution at the sacrifice of local government and bond rule.
6. Because it opens the way for retroactive taxation of all public officers' and employees' back salaries.
7. Taxing the public officers' and employees' back salaries during the period of 12 years would be a very great hardship and would no doubt result in the ruin of many officers and employees, particularly in the lower salary and wage brackets.

And whereas the city clerk be, and he is hereby, directed to send a certified copy of this resolution to the Pennsylvania United States Senators and the Congressman from this district.

We hereby certify that this resolution passed council this 20th day of December A. D. 1938.

WILLIAM WARD, JR., *Mayor.*

Attest:
[SEAL] BENJAMIN NEWSOME, *City Clerk.*

SAN JOSE

RESOLUTION

Whereas an effort is being made to subject the income from State and municipal bonds, and the salary of State and municipal employees and the revenues of municipally owned public utility bodies to the Federal income taxation; and

Whereas the Municipal Employees Federation of the City of San Jose believe such effort to be inimical to the best interests of the city of San Jose and the people of the State of California; Now, therefore, be it

Resolved by the Municipal Employees Federation, That we condemn any and every attempt to require retroactive taxation of the income and salaries of any group of public employees who have been heretofore considered exempt from any such taxation.

We believe that such a policy of retroactive taxation would be a punitive measure, unduly penalizing a group of public employees which have acted in good faith.

We further believe that no attempt should be made to tax the income of State and local bonds already outstanding.

We are not opposed to the taxation of salaries of State and municipal employees by the Federal Government if the Federal Government at the same time permits the taxation of Federal employees by States having local income-tax laws.

That while this federation is opposed to Federal taxation of the income from State and municipal bonds already outstanding, for such a measure would be unfair to the present holders of such bonds, it is opposed to the taxation of State and municipal bonds to be issued in the future for entirely different reasons. The immediate results of such taxation by the Federal Government could cause an increase generally in the cost of local government. The cost of local government would increase in proportion to the increase of Federal revenue from this source. Such a form of taxation would tend toward a greater centralization of revenues in the Federal Government with a consequent increase in the revenue difficulties of local governments.

That this federation is opposed to the taxation of revenue or income on public bodies irrespective of whether or not such services are generally classed as governmental functions, or whether they are performing so-called proprietary functions.

That we oppose any attempt on the part of the Federal Government to tax the revenues of the State or of its municipalities and any attempt to tax State or municipal bonds or the salary of State and municipal employees, unless and until the consent of the States of this Nation are first obtained through a proper constitutional amendment; be it further

Resolved, That this federation requests the Congressman elected from this congressional district to carry out the sentiments expressed in this resolution.

Adopted by the unanimous vote of the executive committee of the Municipal Employees Federation of the City of San Jose, Calif., on this 28th day of October A. D. 1938.

Attest:

H. J. FLANNERY, *President.*
JOHN AKIN, *Secretary.*

[SEAL]

ROANOKE

In the Council for the City of Roanoke, Va., the 9th day of January 1939. No. 5849

A resolution condemning proposed legislation imposing taxes on incomes derived from State and municipal securities, and requesting Senators Carter Glass and Harry F. Byrd and Representative Clifton A. Woodrum to oppose such proposed legislation.

Whereas it appears that a move will be made during this session of Congress to subject to taxation incomes from future issues of State and municipal securities, and

Whereas such a Federal tax would be reflected in higher interest rates upon bonds issued by the States and their municipalities, and this increase in interest rates would result in increasing the tax burden of the citizens of the States and municipalities issuing bonds; and

Whereas such legislation would tend to make the States and their instrumentalities of government completely subordinate to the United States, and thereby do

violence to the fundamental concepts upon which the Federal Government was founded: Therefore be it

Resolved by the Council of the City of Roanoke, Va., That it is the sense of this body that no legislation should be enacted by the Congress of the United States taxing incomes derived from future issues of State and municipal securities; be it further

Resolved, That this council's opposition to such legislation be made known to Senators Carter Glass and Harry F. Byrd and to Representative Clifton A. Woodrum; and they are hereby requested to vigorously oppose any bill providing for such taxation; be it further

Resolved, That the city clerk be, and he is hereby, directed to mail a copy hereof to said Senators and Representative.

Attest:

[SEAL] L. D. JAMES, *City Clerk.*

FRESNO

The Commission of the City of Fresno resolves as follows:

That the city of Fresno is unalterably opposed to the extension of power to the Federal Government to tax municipal bonds. The present proposal before the special Senate committee to tax municipal bonds is, in the judgment of this commission, against the financial interests of the cities of the United States. Such a tax would be reflected in the reduced price for such bonds and this difference would be paid by the local taxpayers. The Federal Government could not possibly collect a net amount from this tax equal to the sum the cities would lose. The proposal is revolutionary and tends to confer totalitarian powers upon the Federal Government, and is wholly and unequivocally bad.

HIGHLAND PARK

REGULAR MEETING OF THE COUNCIL OF THE CITY OF HIGHLAND PARK, JANUARY 16, 1939

Moved by Commissioner Thomas M. MacTaggart. Supported by Mayor Blaine T. Colman

Whereas it has been proposed that Congress enact a statute levying an income tax upon State and municipal securities and the salaries of public officers and employees; and

Whereas under interpretations by the Treasury of a recent United States Supreme Court decision, all State and municipal officers and employees may now be subjected to retroactive Federal taxes on salaries received during the past 12 years: Therefore, be it

Resolved, That the Council of the City of Highland Park is strongly opposed to the taxation of State and municipal securities by the Federal Government unless the consent of the State is first obtained by a constitutional amendment for the following reasons:

1. Because it would establish the power of the Federal Government to compel the States and their agencies to pay an income tax upon their revenues.
2. Because it denies corresponding power in the States to tax the Federal Government except by grace of Federal permission which could be repealed by any subsequent Congress.
3. Because it would establish the power of any subsequent Congress to tax already issued securities of the States and their agencies although they were sold and paid for at a higher price because of exemption.
4. Because it opens the way for retroactive taxation of all public officers' and employees' back salaries.
5. Because it would increase the cost of State and local government and so add to the burdens of the local taxpayers.
6. Because it would foster overcentralization at the sacrifice of local government and home rule.

Be it further resolved, That the Council of the City of Highland Park strongly urges the Senators and Representatives of the State of Michigan in Congress to support legislation prohibiting retroactive Federal taxes on past years' salaries of employees of the State, municipalities, or their agencies, and to oppose Federal taxation of the revenues or outstanding bonds of the State, munici-

palities, or their agencies, and to oppose Federal taxation of future State and municipal bonds, except with the States' consent through constitutional amendments guaranteeing the reciprocal right to tax Federal instrumentalities.

Be it further resolved, That the city clerk be, and he is hereby, instructed and directed to forward certified copies of this resolution to the Senators and Representatives of this State in Congress. Yeas, Commissioners Hayden, Lane, MacTaggart, Patterson, Mayor Colman; nays, 0.

Mr. LAGUARDIA. Now, gentlemen, this proposition is not new. It has been kicking around Congress for the past 20 years. Fifteen years ago today, February the 7th, it was up in the House of Representatives and we voted on it on February the 8th. At that time the House was privileged to count among its Members the following gentlemen who are now in the Senate: Senators Barkley, Byrnes, Connally, Hayden, Hill of Alabama, Thomas of Oklahoma, Tydings, and every one of them voted against it. That is why they are in the Senate today, I guess.

The CHAIRMAN. Might we say that because you voted for it that you are the mayor of New York today?

Mr. LAGUARDIA. No; I voted against it. I generally voted with Mr. Garner in those days.

Gentlemen, we used to say at that time that this idea is the answer to the utilities' prayer, only in this instance the prayer was not from a maiden. It first came up, you will find, at the time that municipalities were taking over private water works, and so on, and particularly the Ohio cities were taking over the traction service.

This is a most deceptive proposition, and one which the uninitiated and inexperienced legislator might readily fall for. I had the benefit of a term as a city official in between my first service in Congress and the time this came up, and had it not been for that experience, I can readily see how I might have been deceived by it.

The argument at the time, 15 years ago today, was entirely different than the one presented today. At that time they urged, not so much on the revenue aspect, but it was rather the position that cities and States were extravagant; that they were spending too much money, and that money was too easy for them to obtain. And then such champions of the poor and such men who wanted to soak the rich as my good friends Ogden Mills and Andrew Mellon, they argued that this was an avenue to escape surtaxes on the part of wealthy people. Of course, coming from these gentlemen, it made a profound impression on the House. The debate was very interesting at the time, and it was very much the same argument as was presented by the representatives of the Treasury Department before your committee.

Now, gentlemen, I want to make it very clear that I am opposing this measure on the merits. I am not urging any constitutional reason. I suppose that some of the gentlemen appearing before this committee will base their opposition on constitutional grounds. I am not. I want to make that clear.

On the merits itself, this measure will not produce the revenue that is anticipated, and it will create a great deal of damage.

Now, let us be perfectly clear about it. Every cent that is collected on a tax derived from interest on a State or municipal bond will be paid by the State or subdivision of the State issuing that bond, and there is no question about that. Such advantage as we may have on tax exemption of our securities is reflected directly in the rate of

interest that we are required to pay. I do not believe there is any doubt about that at all.

Now, the trouble with this proposition is that it simply adds another tax. It does not help the economic situation as a whole, and it creates an additional taxing agency.

What I believe should be done is a thorough study of our entire taxing system, local, city, county, State, and Federal, and to find the way of reducing the number of tax-collecting agencies and eliminating the duplication of taxes by a system of combined and pooled tax collection, with a method of refund. By that I mean we could carry out a proposition we adopted some time ago in our inheritance tax, known for a long time as the Ramseyer amendment, whereby the Federal Government levied certain taxes on inheritances with due credit up to a certain percent to the State. That immediately removed the disparity that existed prior to that time. States having no inheritance tax, and advertising the fact, and in some instances writing into their constitutions—I think Florida and Connecticut—that in order to have a parity among the States, a system of inheritance tax whereby the Federal Government would be the sole collecting agency, returning a certain percentage to each of the States if it affected an estate tax, would reduce the cost of administration, and would increase the revenue both to the Federal Government and to the States. It would end the vicious system of certain competition that exists between the States, particularly neighboring States, where one State is compelled to impose an income tax and another refrains from doing so and advertises that fact. I submit that for the very serious consideration of your committee, the same idea to be followed throughout our whole taxing system.

Now, I can say that there is not a city in this country that is not required at this time to be extra cautious in its financing by reason of the economic conditions. Cities have been taxed for emergency reasons, and almost every city is approaching its borrowing limitation, and some of them have reached it. We must indulge in refunding from time to time. Now, a proposition of this kind is liable to affect refunding, is liable to make refunding most difficult, and, in some cases, prohibitive.

We realize, and you can easily see what will happen, if any obstacle is placed in the refunding program of the city and the State, and I want to submit that for your very serious thought.

The CHAIRMAN. Now, in that connection, Mr. Mayor, the counsel of the joint committee has called my attention to the revenue bill of 1918, which was introduced in the House and passed by the House. It attempted to tax the securities of States and municipalities, but it exempted any bonds which could be called refunding bonds. That bill did not pass in the Senate, and it did not become a law.

But, of course, that is one way by which the problem could be covered.

Mr. LAGUARDIA. I do not recall that. I took a leave of absence in 1918, and was busy elsewhere. We did not do a very good job on that, either.

As I see it, gentlemen, reading the message, the proposal is limited to new issues, and there is no attempt, as I read the message, to tax existing issues.

The CHAIRMAN. That is right

Mr. LAGUARDIA. Now, if refunding bonds are to be classed as existing bonds for the purpose of taxation, then you are going to seriously interfere with the refunding process.

Now, as I see this proposition, I think that one of the chief points has been entirely overlooked, both in the effect and the principle of the proposed plan: It perpetuates and increases an existing evil, causing most of our trouble.

Now, what is the bane of every mayor? It is what we call the dead cats, the old outstanding indebtedness, and it is a tremendous burden on every community. The trouble is our interest rates are too high, and what ought to be done is simply to reduce the interest rate on securities where there is little risk or no risk involved.

This proposition does not do it. It increases the interest rates, and increases the burden to the subdivisions of the States.

Now, in the course of the general study of the whole taxation problem, this fact is brought up, I believe, that there is the opportunity of doing something very effective which would reflect on interest rates in general.

If local bonds are to be taxed, then tax the interest rate and not the income. By that, I mean, take a 4-percent bond and tax everything over 2 percent, but refund that amount to the issuing source. Thereby, you will relieve the burden of every taxpayer of this country, because you will lift a load from their backs immediately; and, gentlemen, I say there is no justification for any interest rate over 2 percent on a sound municipal bond, because, if you examine carefully the price of these bonds, you will find the yield is just about 2 percent. It is a sound, safe investment, with no risk involved, and, by limiting it to 2 percent, through the medium of taxing over that rate and refunding to the issuing source that amount, whether county, municipality, or State, the sum total of the gain, the economic benefits, will be far greater than the additional burden and cost that this plan proposes, and the revenue it would bring in and the confusion it would cause and the embarrassment which would result to many cities in this country.

Senator TOWNSEND. Mr. Mayor, have you made any estimate of what revenue that would bring in?

Mr. LAGUARDIA. No. But, I think, if you will take the Lutz report, he has got many figures there, and if you will take the total of outstanding State, municipal, county, irrigation, school, and other local bonds, and then take the total interest on that, the result of that would be more money for industry and you will see, if it is a tight money market, you will not be able to dispose of them at the interest you would have to pay. I was able to dispose of my bonds because the yield is now just about 2 percent, and my bonds are selling at a premium. Jesse Jones made over three or four million dollars on my bonds; the R. F. C. made it, I mean.

As the Conference of Mayors suggested to the Treasury Department, I think 4 years ago, cities which are sound and which have an approved budgetary system should be permitted to borrow from Government funds, Postal Savings, and various insurance funds, if the money becomes tight by reason of going into industry as private investment.

Now, I am just about to issue a little over $300,000,000 of bonds, if our negotiations for the unification of the rapid transit system is accepted, and this will throw us right out of gear, for the tax will hit us right between the two eyes, and will hamper the negotiations.

Many municipalities are now proposing to construct new water works. We are spending at this time, for additional water supply, something like 250 or 300 million dollars, and are appropriating $55,000,000 that we are spending on contracts now in construction.

If this country is to go on developing, this certainly is a wrong approach, and I want to make it very clear that it is not only the difficulty in meeting the excess cost of money for future issuance, but also that refunding may be impaired; and, I repeat, if you take refunding out of it, there is going to be very little revenue in the next few years, because we have all borrowed by reason of the emergency, and have taken advantage of the grants of the Federal Government and have all gone into construction and borrowed.

In addition to this, we are contemplating building a tunnel or bridge connecting Manhattan with Brooklyn, and that will cost, for the bridge around $32,000,000, and for the tunnel around $85,000,000, and if this legislation is enacted, we will have to throw up the sponge, for we have calculated to the penny of the revenue and have depended entirely on the fact that we would find a market at a low rate of interest for this improvement.

That situation, gentlemen, exists throughout the country today. There is no difference. Every mayor has the same kind of headache, and we are all up against it.

This, I think, is the worst possible time to even consider a proposition of this kind, but it is the time to consider a general study of the whole taxing situation with a view of reducing the collecting agencies, and bringing about uniformity, in order to eliminate discrimination among the States, and increasing the revenues both of the States and of the Federal Government, and I trust that this committee will give some thought to that idea because that will do us a great deal of good and reflect in interest rates on bonds. I am not talking about speculative investments, but on bonds where there is little risk, and it will have an effect on industry and perhaps the railroads.

The CHAIRMAN. Any questions, gentlemen, of Mayor LaGuardia?

(No answer.)

The CHAIRMAN. Thank you very much, Mr. Mayor.

We will suspend now until 2:30 p. m.

(Whereupon, at 12 noon, a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The special committee met pursuant to recess at 2:30 p. m., Senator Prentiss M. Brown, chairman, presiding.

The CHAIRMAN. The committee will come to order. We will now hear from Mr. Frank C. Ferguson, chairman of the Port of New York Authority.

STATEMENT OF HON. FRANK C. FERGUSON, CHAIRMAN OF THE PORT OF NEW YORK AUTHORITY

Mr. FERGUSON. Mr. Chairman and gentlemen of the committee, with the committee's permission, I would like to discuss briefly the effect of the proposed Federal tax on State and municipal securities, upon such revenue-producing State agencies as the Port of New York Authority. By way of establishing my familiarity with the subject of financing State agencies, may I say that I have served as a commissioner of the Port of New York Authority since 1924. I had the honor to serve as vice chairman from 1928 to 1934 and since that time I have been chairman. By reason of my 15 years' experience with that agency and because I am a banker by profession, I have always been intimately associated with the fiscal affairs of what we like to think of as the first great self-liquidating State agency in this country.

The Port of New York Authority is what the lawyers call a "municipal corporate instrumentality" of the States of New Jersey and New York. In my own language it is an agency created by two States under a solemn treaty (signed in April 1920) in order more effectively to develop the Port of New York District. The Port of New York Authority should not be regarded as a thing apart from the States—it is the States' arm for port development and improvements.

It is governed by a board of 12 commissioners, 6 from each State; all serve without compensation; every action of the board is reported to the Governors of New York and New Jersey; they have opportunity to review what we do and in certain instances to veto our action.

Our principal activities are concerned with port coordination, promotion, and development. All of the powers of the Port Authority emanate from the "planning and development of the port of New York." The authority is constantly engaged in making studies of channel improvements, establishment of anchorage areas, and similar subjects. It takes a leading part in defending the port against discriminatory freight rates and eliminating other barriers to the free flow of commerce. It has forwarded a progressive unification of existing railroad facilities in the port district. It has constructed Manhattan's first great inland freight terminal, which President Roosevelt once characterized as the first great post office for freight. As part of its efforts to coordinate transportation facilities in and through the port district, the authority has constructed large interstate vehicular crossings. These include the George Washington Bridge and the Lincoln Tunnel linking the Island of Manhattan with the New Jersey mainland. In addition there are other bridges, and there is, of course, the operation for the States of New York and New Jersey of the Holland Tunnel, the first great vehicular tunnel in the world.

Since its inception, the port authority has issued some $293,000,000 of its own securities. In return the authority has given the residents of New York and New Jersey and the Nation at large a rapid, efficient, and economical means of crossing by motor car and truck from New York to New Jersey and vice versa. It has coordinated the flow of less-than-carload freight through Manhattan by the construction and operation of its inland-freight terminal. It has constructed four bridges, a vehicular tunnel, and refinanced another such tunnel without the expenditure of a single penny of the taxpayers' money. While

these vehicular tunnels and bridges could have been constructed as efficiently by the New York State Department of Public Works or the New Jersey State Highway Commission, in either or both of these cases the cost would have been charged directly to the taxpayer in the form of real estate or other taxes. Instead, the States of New York and New Jersey chose to create and designate a separate and bi-State agency to do the work and charge the cost to the users of the improvements.

This was effectuated by the port authority issuing its own securities, backed entirely by a pledge of facility revenues. The interest rate on these securities varied from a high of 5.11 percent (yield to maturity), or an average of 4½ to 4¾ percent (yield to maturity) on our early issues, to a low of 2.833 percent (yield to maturity), or an average of 3¼ percent (yield to maturity) on our more recent issues. The recent low rates of interest were obtained after our facilities were in operation and its credit established. Every dollar of these bonds was sold to the investing public as being free from income taxes, not alone by the States, but by the Federal Government. At the very outset of our sales, the tax-exempt feature of the bonds was found to be so important that a legal opinion was sought from Mr. Charles Evans Hughes, who had retired from the United States Supreme Court and who was then a practicing lawyer in New York. Mr. Hughes' opinion was sought upon the tax immunity of Port of New York Authority securities. He carefully considered the legislation creating the port authority and he concluded, on the basis of the United States Supreme Court decisions, including *Pollock* v. *Farmers Loan & Trust Co.* that (I quote):

* * * the bonds issued by the port authority will be on the same footing as State and municipal bonds issued for governmental purposes and are not subject to taxation by the Federal Government.

The income of these bonds will be likewise free from Federal taxation for the reason that a tax upon the income of the bonds is in substance and in legal effect a tax upon the bonds themselves and upon the borrowing power of the State confided to its instrumentality.

At this point, Mr. Chairman, I would like to file for the record a copy of Judge Hughes' opinion.

The CHAIRMAN. That will be received.

(The opinion referred to by Mr. Ferguson follows:)

NEW YORK, *November 10, 1925.*

Hon. JULIAN A. GREGORY,
Chairman, the Port of New York Authority.

SIR: In response to the request for my opinion upon questions relating to the validity of the organization of the Port of New York Authority, its powers and immunities, and the status of the bonds to be issued by it for the construction of the bridges over the Arthur Kill, I beg to say:

The Port of New York Authority is a public corporation created by a compact between the States of New York and New Jersey with the consent of the Congress of the United States. Its creation was due to the need of the cooperation of the two States in the development and coordination of the terminal, transportation, and other facilities of commerce in the territory in and around the port of New York. The compact was authorized by chapter 154 of the Laws of 1921 of the State of New York, and chapter 151 of the Laws of 1921 of the State of New Jersey, and was approved by joint resolution of the Congress of August 23, 1921.

The compact established a "Port of New York District" consisting of defined territory. It created "The Port of New York Authority" consisting of six commissioners, three from each State. The port authority was constituted as a body, corporate and politic, with authority to purchase, construct, lease, and/or operate any terminal or transportation facility within the district, and to make

charges for the use thereof, and for any of such purposes to own, hold, lease, and/or operate real or personal property, to borrow money and secure the same by bonds or mortgages upon any property held or to be held by it. These powers were not to be exercised until the legislatures of both States should have approved a comprehensive plan for the development of the port. It was also provided that the port authority should have such additional powers and duties as might thereafter be delegated to or imposed upon it from time to time by the legislature of either State concurred in by the legislature of the other State. Power was also granted from time to time to make plans for the development of the district supplementary to or amendatory of any plan theretofore adopted, and such plans, when approved by the legislatures of the two States, were to have the same effect as if incorporated in the compact. Each State made provision for the appointment of commissioners (New York Laws of 1921, ch. 203; New Jersey Laws of 1921, ch. 152).

In 1922 the legislatures of the two States approved the comprehensive plan of development and specifically granted power to the port authority to carry it out (New York Laws of 1922, ch. 43; New Jersey Laws of 1922, ch. 9). The consent of Congress to the execution of the comprehensive plan was given by the joint resolution of July 1, 1922.

In 1924 express authority was given by the legislature of each State to the port authority to construct, operate, maintain and own, two bridges, with the necessary approaches; one across the Arthur Kill, between Perth Amboy on the New Jersey side and Tottenville on the New York side (New York Laws of 1924, ch. 230; New Jersey Laws of 1924, ch. 125); and another bridge across the Arthur Kill, between Howland Hook, Staten Island on the New York side, and Elizabeth on the New Jersey side (New York Laws of 1924, ch. 186; New Jersey Laws of 1924, ch. 149). With respect to each bridge, power was granted to acquire property by condemnation proceedings. By a joint resolution of March 2, 1925, Congress gave its consent to the construction, maintenance, and operation of these two bridges, in accordance with the provisions of the act of Congress of March 23, 1906. It was provided in this act that construction should be commenced within 3 years and the bridges should be completed within 6 years from the date of the passage of the act and that, in default thereof, the authority granted should cease and be null and void.

In each of the acts of the State legislatures authorizing the building of these bridges provision was made as to the issue of bonds by the port authority as follows:

"SEC. 4. The said bridge shall be built and paid for in whole or in part out of moneys to be raised by the port authority on bonds or other securities or obligations issued or incurred by it pursuant to article six of the said compact or treaty. The said bonds or other securities and any other obligations which the port authority may incur shall be issued and incurred upon such terms and conditions as the port authority may deem proper. As security therefor the port authority is authorized and empowered to pledge the revenues and tolls arising out of the use of the bridge until such time as the sums borrowed therefor are fully amortized and repaid."

In aid of the construction of the bridges, the legislature of New York appropriated $800,000 to be paid in two annual instalments of $400,000 each (one instalment to be available during the fiscal year beginning in 1925, and the other during the succeeding fiscal year). It was also provided that during the three succeeding fiscal years, the commissioners of the New York State Bridge and Tunnel Commission constituted by chapter 178 of the Laws of 1919, should pay over to the port authority $400,000 in each year from the tolls and charges collected for the use of the tunnels constructed by the commission to the extent that such sum should be available after payment of expenses of maintenance and operation and the deduction of New Jersey's share of the surplus, as stated. The intent of the act, as set forth, was that a fund of $4,000,000 should be made available to the port authority as an advance for the construction of the two bridges, one-half to be provided by each State (Laws of New York 1925, ch. 210). In the same year the legislature of New Jersey appropriated for the same purpose $2,000,000, payable in five equal annual instalments (Laws of New Jersey 1925, ch. 87). Each of these acts provides as follows:

"The balance of the money needed for the construction of the said bridges and incidental purposes shall be raised by the port authority on its own obligations secured by the pledge of the revenues and tolls arising out of the use of the said bridges, all in accordance with the provisions of the laws authorizing and governing the construction and operation of the said bridges.

"As security for obligations so issued and the moneys so appropriated, the revenues and tolls arising out of the use of the said bridges shall be pledged to the repayment of the entire issue of bonds and other securities for the construction thereof, together with the interest, and the repayment of the moneys appropriated by the State; it being the declared policy of the State that the said bridges, so far as the payment of the bonds or other securities issued for the construction thereof, together with the repayment of the moneys advanced by the State, shall in all respects be self-sustaining."

On consideration of the provisions of the compact and of the legislation to which I have referred, I have reached the following conclusions:

First. The compact between the States of New York and New Jersey is valid and in effect.

The compact was duly authorized by the legislatures of the two States and the consent of the Congress was given to it. There can be no doubt that the compact falls within the provision of subdivision 3 of section 10 of article I of the Federal Constitution, permitting compacts between States with the consent of Congress. It does not constitute "a treaty, alliance, or confederation" within the meaning of the prohibition of subdivision I, section 10, article I, but falls within the class of "compacts and agreements" under subdivision 3 as it relates to the terminal, transportation, and other facilities of commerce within the district, and thus belongs to the category of internal regulations for the mutual comfort and convenience of States bordering on each other (2 Story on the Constitution, sec. 1403; *Virginia* v. *Tennessee* (148 U. S. 503, 519)). The exercise of authority under the compact is necessarily subject to the control of Congress over interstate commerce, and in the joint resolution giving the consent of Congress, there is express provision that nothing in the compact "shall be construed as impairing or in any manner affecting any right or jurisdiction of the United States in and over the region which forms the subject of said agreement."

The comprehensive plan upon which the exercise of the powers granted to the port authority was conditioned by the compact was duly approved by the legislatures of both States and received the consent of Congress. Commissioners have been duly appointed and the compact must be regarded as effective and the port authority as duly constituted.

Second. The Port of New York Authority created by the compact is a public agency of the two States.

The port authority is manifestly not a private agency. It is established for public purposes. These purposes relate to the development of terminal, transportation, and other facilities of commerce in the port of New York. The port authority consists of commissioners appointed in the manner defined by the legislatures of the two States; that is in the case of New York, by the Governor, with the advice and consent of the Senate, and in the case of New Jersey, directly by the legislature in the first instance and thereafter, as vacancies occur, by the Governor with the advice and consent of the Senate. The authority to be exercised, as shown by the compact, the comprehensive plan, and the supplementary legislation, is a public authority; that is it is an authority granted by the legislatures and to be exercised on behalf of the public by representatives of the States. The power of the States to establish public agencies for harbor improvements, for drainage and reclamation purposes, to aid navigation and to provide facilities for commerce is not open to question. (*County of Mobile* v. *Kimball* (102 U. S. 691); *Minnesota rate cases* (230 U. S. 352, 403, 404); *Houck* v. *Little River Drainage District* (239 U. S. 254, 261, 262); *Milheim* v. *Moffat Tunnel Improvement District* (262 U. S. 710, 717)).

The port authority is none the less a public instrumentality because it is the instrumentality of two States instead of one. Each State has the constitutional power to establish an instrumentality of this character and each State has the constitutional competency, with the consent of Congress, to enter into a compact with another State to establish a similar joint instrumentality. The Port of New York Authority must be regarded as validly constituted as the competent public agency of both States.

Third. The port authority has been duly authorized to build the two bridges over the Arthur Kill. This authority is given in express terms by the legislation to which I have referred, and Congress has duly given its consent. This consent is still operative as the time allowed for the beginning of the construction of the bridges has not expired.

The authority to acquire property for this purpose and, if necessary, to institute condemnation proceedings, is expressly granted, and as the purposes are public purposes, the authority must be deemed to be validly granted.

Fourth. The moneys required for the construction of the bridges are to be derived from moneys made available by the legislative action of the two States and by bond issues.

The two States have enacted legislation providing for $4,000,000, or $2,000,000 each. The action of each State is conditioned upon an equal amount being made available by the other.

The appropriation of $2,000,000 made by New Jersey is to be paid in five annual installments of $400,000 each. While the appropriation bill was pending in the legislature of New Jersey, the attorney general of the State, upon the request of its Governor, gave his opinion, under date of March 5, 1925, that the port authority is a municipal, corporate instrumentality of the States of New York and New Jersey, and as such is legally a proper body to receive appropriations made by the legislature for its legitimate purposes; that the legislature could make a definite appropriation to the objects of an instrumentality of the State; that there was no requirement that the money appropriated must be actually in hand; and that if an appropriation were made, there would be no debt or liability of the State created or the loan of the credit of the State within the prohibition of the constitution of the State. The attorney general also said that in his opinion if under the solemn agreement made between the two States, the appropriation of $2,000,000 were actually made, it would be beyond the power of a succeeding legislature to repeal such appropriation, as the repealer would be void as an impairment of contract forbidden by both the Federal and State constitutions. The attorney general relied upon the authority of the Supreme Court of the United States in *Greene* v. *Biddle* (8 Wheat. 1) and of the Supreme Court of California in *McCauley* v. *Brooks* (16 Calif. 11).

The Legislature of New York, as already stated, appropriated $800,000 out of the State treasury, that is $400,000 for each of the first 2 fiscal years beginning July 1, 1925, and it was provided that $1,200,000 should be paid over the next 3 succeeding fiscal years in instalments of $400,000 each from tolls and charges collected for the use of the vehicular tunnel being constructed by the New York State Bridge and Tunnel Commission. The Constitution of the State of New York provides that neither the credit nor money of the State shall be given or loaned to or in aid of any association, corporation, or private undertaking (art. VIII, sec. 9; see also art. VII, sec. 1). This prohibition is not applicable as the port authority is a public agency created for public purposes. It is also provided in the State constitution that no money shall be paid "out of the treasury of the State or any of its funds, or any of the funds under its management, except in pursuance of an appropriation by law, nor unless such payment be made within 2 years next after the passage of such appropriation act" (art. III, sec. 21). There is no difficulty so far as the appropriation out of the treasury for the first 2 years is concerned. The provision for the other payments has been made on the assumption that the moneys described are not to be paid out of the treasury of the State, or any of its funds, or any of the funds under its management, and hence is not in conflict with the constitutional prohibition. In my opinion, this view is correct. The tunnel for the use of which the tolls and charges are to be collected by the New York State Bridge and Tunnel Commission is not yet built, and no part of the tolls and charges is now in the treasury of the State or in any fund of the State, or in any fund under its management. There is no constitutional requirement that these tolls and charges should ever be paid into the treasury of the State or become a part of any such fund. The tolls and charges are to be imposed and received under a contract made by the commission with the State of New Jersey. Pursuant to this contract, these moneys are to be deposited to the joint account of the commissions of the two States respectively empowered to deal with the matter and the income is to be divided monthly.

The New York act provides that the tolls and charges shall be fixed at such amount as will pay the estimated cost of administration, maintenance, and operation, and will, in addition, pay within 20 years the amortized cost of construction (laws of 1919, ch. 178, sec. 9). It would seem to be clear that it would have been competent for the legislature in the original acts constituting the New York State Bridge and Tunnel Commission to dispose of these tolls and charges in such manner and for such public purposes as the legislature might deem best. It could have provided that the tolls and charges should be directly applied by the commission, or through the joint action of the two commissions, to the defraying of the expense of maintenance, operation, and construction, or the retirement of bonds, if bonds had been authorized and issued for the purposes of construction, or for the building of another tunnel or public improvement. Such legislative action would not, in my judgment, have constituted an appropriation out of the treasury or funds of the State within the meaning of the constitutional provision.

I think that the legislature had not lost its authority over the enterprise by the passage of the earlier acts and it was equally competent for the legislature, in the act under consideration and before these expected tolls and charges were paid into the treasury of the State or became part of any of the funds of the State, or of any funds under its management, to provide that these tolls and charges should be applied to the expenses of operation and maintenance, to suitable amortization charges, that New Jersey should have her proper share of the surplus, and that the remainder of the surplus should be devoted to any public purpose, including payment to the port authority (matter of *Clark* v. *Sheldon*, 106 N. Y. 104, 111, 112; see also, *Board of Supervisors of Seneca County* v. *Allen*, 99 N. Y. 532; *People ex rel. Einsfeld* v. *Murray*, 149 N. Y. 367; *People ex rel. Eisman* v. *Ronner*, 185 N. Y. 285; *Gaynor* v. *Port Chester*, 230 N. Y. 210; *State ex rel. Sherman* v. *Pape*, 103 Wash. 319).

Fifth. The port authority is authorized to borrow money, and to issue its bonds, for the construction of the two bridges and incidental purposes, such bonds to be secured by the tolls and charges derived from the bridges.

This authority is expressly conferred by the compact between the two States and by the legislation of each State specifically authorizing the building of the bridges and providing for the financing of their construction as already stated. The port authority is empowered by the acts providing for the building of the bridges to establish and levy such tolls and charges as it may deem convenient or necessary for the operation and maintenance of the bridges and to insure at least sufficient revenue to meet the expenses of the construction, operation, and maintenance thereof and to make provision for the payment of the interest upon and amortization and retirement of the bonds (New York Laws of 1924, ch. 180, sec. 3 ch. 230, sec. 3; New Jersey Laws of 1924, ch. 125, sec. 3; ch. 149, sec. 3). The financing act of each State provides that it is the declared policy of the State that the two bridges, so far as the payment of the bonds issued for the construction thereof is concerned, together with the repayment of the moneys advanced by the State, shall in all respects be self sustaining (New York Laws of 1925, ch. 210, sec. 3; New Jersey Laws of 1925, ch. 37, sec. 3).

In my opinion, this legislation places upon the port authority the duty to provide adequate tolls and charges for the purposes described and the performance of this duty may be compelled by any court of competent jurisdiction.

Sixth. The port authority may include in its bonds the pledges of the two States and make these pledges a part of the contract with the bondholders.

The financing act of each State provides that the port authority may include in the bonds issued by it for the construction of the two bridges and incidental purposes such part of the financing act as shall seem proper "as evidence of the foregoing agreements made by the State with the holders of the said bonds or other obligations, and thereupon the same terms so included shall become a contract between the State and the holders of said bonds or other obligations" (New York Laws of 1925, ch. 210, sec. 6; New Jersey Laws of 1925, ch. 37, sec. 6). It is thus competent for the port authority to include in the bonds the provision made by each State for the advance of moneys toward the construction of the two bridges, and these provisions, assuming that they have been validly made as above stated, will constitute when incorporated in the bonds issued to and held by bondholders irrevocable contracts.

Each State also provides in the financing act that the port authority shall not be required to pay any taxes or assessments upon any of the property acquired by it for the construction, operation and maintenance of the two bridges (New York Laws of 1925, ch. 210, sec. 7; New Jersey Laws of 1925, ch. 37, sec. 7).

Each State also pledges to and agrees with those taking the bonds issued by the port authority for the construction of the two bridges and incidental purposes that the State will not authorize the construction or maintenance of other highway crossings for vehicular traffic of the waters of the Arthur Kill between the two States in competition with the said bridges, nor will it limit or alter the rights now vested in the port authority to establish and levy such charges and tolls as it may deem convenient or necessary to produce sufficient revenue for the purposes above stated until the bonds are fully paid off and discharged, provided that such crossings shall be considered as competitive with the bridges crossing the Arthur Kill only if they shall form a highway connection for vehicular traffic between the two States across or under the Arthur Kill, and provided further that nothing contained in the act shall preclude the authorization of such additional interstate crossings if and when adequate provision shall be made by law for the protection of the bonds (New York Laws of 1925, ch. 210, sec. 5; New Jersey Laws of 1925, ch. 37, sec. 5).

These, as well as the other provisions above noted, when incorporated in the bonds issued to and held by the bondholders will be irrevocable as a part of the contract with the bondholders (*Stearns* v. *Minnesota*, 179 U. S. 223; *Wright* v. v. *Georgia Railroad & Banking Co.*, 216 U. S. 420; *Wright* v. *Central of Georgia Railway Co.*, 236 U. S. 674).

Seventh. The bonds issued by the port authority for the construction of the two bridges and the income therefrom will be exempt from both Federal and State taxation.

By the comprehensive plan approved by the legislatures of both States, it is provided as follows:

"The bonds or other securities issued by the port authority shall at all times be free from taxation by either State." (New York Laws of 1922, ch. 43, sec. 8; New Jersey Laws of 1922, ch. 9, sec. 8.)

This immunity from taxation of the bonds or other securities issued by the port authority when the bonds have been issued and are in the hands of bondholders will constitute, in my judgment, a contract with each State protected from impairment by the Federal Constitution (*Wright* v. *Georgia Railroad & Banking Co.*, 216 U. S. 420).

The immunity of the bonds from Federal taxation follows from the fact that, as already stated, the port authority is a public agency, a governmental instrumentality of the two States. It is explicitly declared to be such in the act of each State providing for the financing to build the two bridges (New York Laws of 1925, ch. 210, sec. 7; New Jersey Laws of 1925, ch. 37, sec. 7), and this declaration is fully warranted by the nature of the functions of the port authority and of the purposes for which it has been established. In this view, the bonds issued by the port authority will be on the same footing as State and municipal bonds issued for governmental purposes and are not subject to taxation by the Federal Government (*Collector* v. *Day*, 11 Wall. 113; *United States* v. *Railroad Company*, 17 Wall. 322, 327; *Van Brocklin* v. *Tennessee*, 117 U. S. 151, 178; *Mercantile Bank* v. *New York*, 121 U. S. 138, 162; *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429, 584–586; id., 158 U. S. 601, 618).

The income of these bonds will be likewise free from Federal taxation for the reason that a tax upon the income of the bonds is in substance and in legal effect a tax upon the bonds themselves and upon the borrowing power of the State confided to its instrumentality (*Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429, 584–586; id., 158 U. S. 601, 618).

For a similar reason, the immunity from taxation given by the legislation of the two States providing for the construction of the two bridges, and inviting the lending of money upon the bonds of the port authority, must be deemed to extend not only to the principal of the bonds but to the income therefrom.

Eighth. The legislation of both States declares that the bonds issued by the port authority for the construction of the two bridges and incidental purposes shall constitute "securities in which all public officers and bodies of this State and of its municipal subdivisions, all insurance companies and associations, all savings banks and savings institutions, including savings and loan associations, executors, administrators, guardians, trustees, and all other fiduciaries in the State may properly and legally invest funds within their control." (New York Laws of 1925, ch. 210, sec. 8; New Jersey Laws of 1925, ch. 37, sec. 8).

Respectfully yours,

(Signed) CHARLES E. HUGHES

Mr. FERGUSON. Ever since this time investors in port authority bonds have relied upon the opinions of Mr. Hughes and of Messrs. Thomson, Wood & Hoffman, bond counsel, as well as upon the opinions of the port authority's own general counsel that port authority bonds are immune from tax. When the port authority arranged to sell one issue of its securities to the Federal Government, in connection with a W. P. A. loan, which I might say parenthetically has since been refinanced on our own credit, the Public Works Administration insisted upon an opinion of independent bond counsel which they selected, to the effect that port authority bonds were immune from Federal income taxes.

As a banker of many years' experience, I will state to this committee that in my opinion the tax-exempt feature of these bonds meant a saving to the States of at least 1 percent in the interest rate; and

further during the early years of the existence of the port authority, it meant the difference between selling and not selling the issue. That sounds like a broad statement, but at the time there was no precedent for what we proposed to do.

The CHAIRMAN. I do not see how you reached that 1-percent figure, if your average was 4 percent. Is it that you imply by that the Federal tax will amount to practically 25 percent?

Mr. FERGUSON. Yes, on securities of this character, you see we are not dealing with the same kind of a security as a municipal security, that in security of a municipality which carries with it the taxing power. Here you have a security which is tantamount to a public utilities security, which depends entirely for its interest income on the polls which are collected.

The CHAIRMAN. It is a revenue bond?

Mr. FERGUSON. Yes, it is a revenue bond.

The CHAIRMAN. My point is a little different. You say that if these bonds were not tax-exempt that it would result in 1-percent increase in the rate. It seems to me that is over and beyond what the Federal tax would be. Do you think the interest rate would be greater than the average Federal tax?

Mr. FERGUSON. Yes, I do, because the authority has no taxing power. I think you have got to differentiate between the securities of the municipality, which has taxing power, and one which does not have. That is where the difficulty comes in, between securities of this kind and municipal securities.

The CHAIRMAN. I see your point I think.

Mr. FERGUSON. I might say that is perfectly true, Senator. You have to bear in mind that this authority started out with no capital at all. When it first issued its securities it did not have a penny of capital behind its bonds. They had to be sold entirely on the engineering estimates of the particular enterprise.

Senator TOWNSEND. What capital has it now?

Mr. FERGUSON. The capital has accumulated, if you call it that, through the earnings that we have attained.

Senator TOWNSEND. You have retained the earnings?

Mr. FERGUSON. Yes, sir; its capital or its surplus has been created by the earnings and reserve.

The CHAIRMAN. I do not think your mind and my mind quite meet. Here we have this question. The estimate of Professor Lutz was that municipal bonds and State bonds would have an average rise in interest charge of 60 points. The testimony of Mr. Tremaine was that it would have a rise of 75. I take it you are making an estimate in your statement that it would be 1 percent.

Mr. FERGUSON. On securities of the Port of New York Authority.

The CHAIRMAN. My point is, it seems to me that the amount of the additional interest charge would be the amount of the Federal tax, and it seems to me it would not average 25 percent, and your estimate is that it would be 25 percent in your interest charge. Do I make myself clear?

Mr. FERGUSON. Yes; but you remember, Senator, Mr. Tremaine this morning referred to Ohio municipal tax securities, some of which were issued without a tax, and some with a tax, and he showed you that even in the case of Cincinnati the differential was more than twice as much as the tax saving. Now, of course, you have got to

take into consideration it is not the present tax differential. It is what the public thinks eventually. Of course, it is an estimate at best, but, I am confining my guess if you call it such entirely to the Port of New York Authority securities. Keep this in mind, I do not think if we had not had the tax-free feature in our bond that we could have ever sold our first issue at all.

The CHAIRMAN. The point I am getting down to is this: I do not think that the only reason people buy municipals or State or Federal bonds is because they are tax-exempt. I think there are many other factors that enter into, that enters into a person's mind when he decides to buy a municipal or a Federal security.

Mr. FERGUSON. So do I.

The CHAIRMAN. It seems to me in your calculation and the other gentlemen that is the fact you emphasize. I think that the conclusion they reached is that interest is not the all-compelling feature.

Mr. FERGUSON. It is only one of the things that go into making so-called tax-free bonds desirable. People buy them for security as well as because they are tax-free bonds. There is no question about that.

Senator MILLER. Did I understand you to say you could not have sold the bonds at all if it had not been for the tax-exempt feature?

Mr. FERGUSON. Yes, sir.

Senator MILLER. Why do you say that?

Mr. FERGUSON. You can imagine, as I said before a project which has not one penny of capital, and not one penny of income, which was the situation with respect to the port authority when our first issue of bonds came out. We had to go to the public with an engineering estimate of traffic or revenue, only an engineer's estimate of traffic. Now, it is a most difficult thing to sell an issue of bonds carrying the entire cost of the project based solely on engineering estimates of probable intake.

Senator MILLER. I quite agree with you on that.

Mr. FERGUSON. I am making the statement that if it had not been for this sop so to speak to hand to the investor, I do not think we would have been able to sell them at all.

Senator MILLER. In other words, put another way, the investor was looking for something to avoid taxation?

Mr. FERGUSON. Yes.

Senator MILLER. That is true in all tax-exempt bond issues, isn't it, when you eliminate all of this hurrah about it?

Mr. FERGUSON. Yes; in one way.

Senator MILLER. That is what I thought.

Mr. FERGUSON. There was no experience upon which to estimate the amount of revenues which would be derived from the operation of an interstate bridge, for example. There were, of course, engineers' estimates, but in view of the problematical outcome of the financial success of the venture, I think you will agree with me that the sale of our first issues was quite an accomplishment. I personally am certain that the tax-exempt feature in this case helped to sell the bonds. I am certain that without that feature we might never have had the improvements we now have—except at a direct out-of-pocket cost to the taxpayers of the two States.

I doubt whether any thinking person can fail to see the tremendous value to the State and Nation at large of the work of port development at America's great seaport, which has been accomplished by the

Port of New York Authority. I think it is significant that these accomplishments have been made possible by the use of revenue bonds. And so it is that I call your attention to a recent work on the subject of revenue bonds by John F. Fowler, Jr., published in New York just last year. In the preface to that text, in which the author thoroughly examines the whole subject of revenue bonds, he says:

> Revenue bonds, issued under governmental auspices and depending for their repayment, not upon the public treasury, but wholly upon the earnings of publicly owned improvements—toll bridges, modernized water-supply systems, electric plants and the like—constitute par excellence the logical means of financing the construction of these improvements. In furtherance of a Nation-wide program of self-liquidating public works, the American revenue bond has emerged after nearly half a century from a state of obscure existence into one of brisk activity, * * *.

While I am talking about revenue bonds I do not want, inadvertently to create the impression that revenue bonds as such are any different from the ordinary obligations of a State or city. I see no difference between the bonds which were in fact issued directly by the State of New Jersey to build the Holland Tunnel, say, or those which the State issued through the medium of the port authority to refinance its earlier Holland Tunnel issue. As a matter of fact, I have been advised in my official capacity as chairman of the port authority by Attorney General John J. Bennett, Jr., of the State of New York, that as a matter of constitutional law, there is no distinction, from the tax standpoint, between the bonds of a sovereign State and those issued by the agency of such a State and secured by a pledge of revenues. You will also recall that in the portion of Hon. Charles E. Hughes' opinion which I quoted earlier, he, too, said that the bonds issued by the port authority "will be on the same footing as State and municipal bonds."

Should any attempt ever be made to single out State and city issues of revenue bonds for attack upon their tax-immunity, I can only say—speaking now as a businessman familiar with State financing—that the policy would be most unwise. After all, there is nothing to prevent the State from building vast public improvements by the issuance of its own securities and by charging the cost directly to the general treasury of the State. If by some peculiar quirk, the taxability of these securities should be made to depend upon whether they were issued by the State in the first instance, or by the State through an agency thereof, the only effect would be to cause the States to give up the self-liquidating agencies as a method of accomplishing certain results. In view of the success of such agencies, I submit that would be a most unfortunate result. I subscribe to the view that the States should be left free to select the means and instrumentalities which they find best to perform their duties.

I understand that the committee has indicated at the outset of these hearings that it is not concerned with the taxation of the income of outstanding bonds. You may wonder, therefore, why I express any concern with respect to the proposals now being studied by this committee. The answer is that the port authority is engaged in a refunding and refinancing program. If, because of a Federal tax, we are unable to issue future issues of refunding bonds at the same low rate of interest which now prevails upon our tax-immune refunding bonds,

the orderly completion of our refunding program could be seriously disturbed if not upset.

May I interpolate here. That is one of our difficulties. We built the George Washington Bridge, and we put out a port authority issue, secured by the revenues on that particular bridge. It was an obligation of the port authority, but depended on the revenues of the George Washington Bridge. We have had similar issues on other facilities. Then, we conceived the idea of putting through a general and refunding bond issue, picking up the separate issues, and making one general refunding bond issue, and putting them all on the same basis. There is a call feature, naturally, in our bonds, and as soon as we are able to recall the bonds, we thought to issue a new issue of refunding bonds and retire the existing bonds, and that program we are engaged in doing as rapidly as we can.

The comptroller of the State of New York has estimated that a Federal tax upon the income of State and municipal bonds might result in a 1 percent increase in the interest cost to the issuing body. If this had been true, when the port authority sold its first issues, its present 50-cent toll would have to have been 60 cents—assuming the bonds could have been sold at all. I want to say here and now that a 10-cent toll increase is a matter of grave concern not only to those who manage the port authority on behalf of the State, but to the users of the facilities. As it is, the port authority is constantly being subjected to petitions to reduce tolls. We would indeed be happy if we could, but because of our fixed debt charges even as they now stand, I regret to say that this is impossible. In view of these circumstances, you can more readily appreciate what a 10-cent increase in tolls would have meant in the management and operation of port authority crossings.

The CHAIRMAN. On what unit is that 50 cents toll; is it based on a car, or what?

Mr. FERGUSON. We charge $1 for a truck and 50 cents for a pleasure car.

I have said that the port authority's toll would have been 60 cents instead of 50 cents, if, as the comptroller of the State of New York indicates, the interest rate would increase 1 percent. As a banker I would like to express the opinion that the comptroller's 1 percent estimate might, under some circumstances, be unduly conservative. I say this because the purchasers of long-term bonds which are subject to tax have a way of discounting any future tax rises. That is particularly true in these days when taxes definitely show an upward trend. The investor buying a 30-year bond, and all of our bonds are on a 30-year basis, does not know what the tax rate will be before his bond is fully matured. In his present frame of mind, he is inclined to believe that tax rates will increase substantially. In the face of this situation, he hedges, and the issuer pays for the hedge with a still higher interest rate. And so with tax rates mounting generally and taxpayers being inclined to discount still further increases, it might well be that a Federal tax upon State and municipal securities will result in an increased interest cost to the issuing body of even more than 1 percent.

I feel it is my duty as chairman of the port authority to make one point very briefly. I should like to mention the ridiculous possibility that the revenues of State agencies might be subject to tax. One

need not be versed in the law to understand the dangers which lurk in the theories advanced by the Department of Justice to support the proposal to tax State and municipal securities by a simple act of Congress. As a layman, I can readily see that when the Department argues that the Federal Government can tax any income irrespective of where it comes from, it must also argue that it can tax the income of the State itself. And now, lest the committee think that I am unduly alarmed in suggesting that they give consideration to this phase of the problem, I call attention to the fact that the Government's brief in *Helvering* v. *Gerhardt* actually argued that the port authority itself was subject to Federal tax. Fortunately, the Attorney General of the United States did not succeed in convincing the Supreme Court of this point.

The bi-State agency which the States of New York and New Jersey have selected for the development of the Port of New York Authority is decidedly not a profit-making corporation. When the outstanding debt is retired, the property reverts to the States. In the meantime, all moneys passing through the port authority, as well as all of the physical properties to which it holds title, are held in trust for the two States. However, if its income were taxable, the agency would cease to exist. One may ask, of course, "if this is a self-liquidating agency and there are no profits, what is there subject to income tax?" The answer is that moneys set aside each year to retire debt would not be regarded as deductions from gross income and so the amounts would be subject to tax. If taxed at the corporate rate, we should have to end our work. We should be unable to meet our obligations. Should such a preposterous situation ever obtain, I need only point out that the States would be forced to give up the self-liquidating agency as one of its means of financing State improvements. Of course, if the views advanced by the Department of Justice are pushed to their ultimate conclusion and the revenues of the States themselves are subject to tax, I can only say that in my opinion the States had better lock their capitols and turn the keys over to the Federal Government.

The CHAIRMAN. Are there any questions of Mr. Ferguson?

(No answer.)

The CHAIRMAN. Thank you, Mr. Ferguson.

STATEMENT OF JOHN S. LINEN, VICE PRESIDENT, INVESTMENT BANKERS ASSOCIATION OF AMERICA, CHAIRMAN OF THE ASSOCIATION'S MUNICIPAL SECURITIES COMMITTEE

Mr. LINEN. Mr. Chairman and gentlemen of the committee, I have been asked to speak before your committee by the Conference on State Defense because of my experience in the field of State and municipal finance. Possibly I should briefly review my experience for your information.

I have been engaged exclusively in the State and municipal bond business since 1918, having been continuously identified with large underwriting houses or institutions having a broad interest in bonds issued by many of the States and their political subdivisions. My associations have been with Harris, Forbes & Co., Chase Harris Forbes Corporation and at present, I am vice president of the Chase National Bank, where most of my time is devoted to the State and municipal bond business.

Other activities in the trade have been the following: President, municipal securities committee of the Investment Bankers Association of America 1936–38; president, Municipal Bond Club of New York 1934–35; at present, vice president of the Investment Bankers Association of America.

The above references are simply made for the purpose of qualifying in the capacity in which I understand I am expected to speak. My comments, however, will reflect merely my personal opinions and do not speak for any institution or organization with which I may be officially connected. I wonder if I might at this time attempt to supplement Mr. Ferguson's answer to your inquiry, for I think I have a little different approach.

The CHAIRMAN. That is as to the increased interest?

Mr. LINEN. Yes, and also whether the port might have been successful in selling their securities. At that time I was connected with one of the member houses originally interested in the financing, and it is my opinion that the Port Authority could not have been financed successfully if the bonds had not been tax free.

As he pointed out there was no equity money behind the obligation. I remember very well the careful study we made of the engineer's, of the probable income, and the question we had was as to the feasibility of the project.

The CHAIRMAN. What year was that?

Mr. LINEN. I do not recall. I was with Harris, Forbes & Co. at that time. Mr. Tobin tells me it was in 1921. But I wish to emphasize that the added difference, whether one half of 1 percent, or 1 percent in my judgment would have been sufficient additional cost to have made it very questionable whether the project was a feasible one to sell.

The CHAIRMAN. I asked the question as to the time, for it would seem to depend very largely upon the general market conditions at that time.

Mr. LINEN. It was a pretty close question among the underwriting houses at that time.

Senator MILLER. In other words, the investor was willing to take a chance of putting his money in tax-exempt securities, admitting there was only a difference of a cent or a half a cent, rather than to put it into securities that might become taxable.

Mr. LINEN. I do not follow you.

Senator MILLER. In other words, the taxation feature was the controlling factor.

Mr. LINEN. The tax feature was one of the deciding factors, not in my judgment that people could buy them as tax-exempt securities alone, but there were two features there.

Senator MILLER. The bonds originally issued were 5-percent bonds?

Mr. LINEN. Yes.

Senator MILLER. Now, suppose the interest had been 5½ percent, or even 6 percent, could they have been sold?

Mr. LINEN. I doubt it. I doubt if we as underwriters would have been willing to underwrite the obligation because the additional cost of interest would have made the investment too great a risk. Do I make myself clear?

Senator MILLER. You make yourself plain enough, but I do not agree with your philosophy.

Mr. LINEN. We had the question whether it was a good risk or not, and it is my judgment that they would have turned it down.

ATTITUDE OF MUNICIPAL DEALERS

While I cannot speak for all municipal dealers in the trade, I believe I can reflect an attitude that is generally supported which should be helpful in understanding their approach and my approach to this subject. They do not feel strongly on the subject of tax exemption one way or the other. Municipal dealers generally, in my judgment, would not oppose a constitutional change, provided suitable safeguards accompanied such a change. The elimination of tax immunities should result in a broader market for State and municipal bonds because of the higher return which they would yield the investor. If we should have a situation where outstanding State and municipal bonds continued to enjoy their present exemption and only future bonds were to be taxable, the trading opportunities for dealers would afford a very profitable field of operation for several years to come. The dealers generally have not had occasion to give much consideration to the probable cost to States and municipalities of the elimination of tax immunities because of increased interest rates, as such a change has not been a serious threat until recent months. A study such as that prepared by Dr. Lutz, gives evidence in a concrete way of such substantial additional interest costs as to create some concern regarding the effect of this additional burden on certain States and their political subdivisions and the effect in turn on the security position of their obligations. When these facts are more fully understood, I am not at all sure that there will not be more definite opinions against such a change than now exists in the trade generally.

The principal concern that dealers have who have dealt over a period of years in tax-exempt securities, is that outstanding obligations shall not be subjected to taxation. They purchased such bonds and resold them to their valued customers with the understanding, because of the consistent attitude of the courts in their interpretation of the sixteenth amendment, that these bonds would be exempt from Federal income taxes. Both parties paid prices for the bonds which reflected the value of this exemption. I might add the States and municipalities received the benefit accordingly on the better rates. It would be deemed an act of bad faith if these obligations were now subjected to tax and there is vigorous feeling that every protection should be erected against such contingency.

The attitude and fear of dealers generally is manifested in a resolution which was passed unanimously at the Annual Convention of the Investment Bankers Association of America last fall. As this resolution is directly in point, I would like to make it a part of the record. It reads as follows:

Whereas a proposal has been made to enact Federal legislation to tax the income from State and municipal securities thereafter issued without first submitting the question to the States and obtaining their consent in the form of a constitutional amendment; and

Whereas it is officially contended by the Federal administration that the Federal Government now has that power without amendment to the Constitution; and

Whereas if this contention be enacted into law and judicially sustained, the power to tax thereby established might be applied to previously issued and outstanding obligations of States and municipalities and, in the opinion of eminent counsel, might even be asserted and applied to the revenues on which the States and municipalities themselves depend for their existence; and

Whereas regardless of present assurances to the contrary, the power to tax if so established might by a future Congress be applied to the detriment of holders of

securities purchased in good faith and the distress or destruction of the States and municipalities themselves: Now therefore be it

Resolved by the Investment Bankers Association of America in convention assembled: First, that attention be directed to the resolution adopted by its board of governors on May 7, 1920, and standing continuously since then as the expressed policy of the association as follows:

"It is the sense of this board that the Investment Bankers Association of America advocate the adoption of an amendment to the Constitution of the United States empowering on the one hand the Federal taxation of the income from future obligations of the States and their political subdivisions and on the other hand the taxation of future obligations of the United States by the States and their political subdivisions, in both cases with proper safeguards limiting such taxation;"

Second, that this convention supplement such resolution to include the obligations of instrumentalities and agencies of the States and their political subdivisions on the one hand and the instrumentalities and agencies of the Federal Government on the other hand; and

Third, that this convention record itself as opposed to any method for the accomplishment of this purpose other than by constitutional amendment.

There will be noted in the above resolution an expressed fear of the legislative method because this may give inadequate protection and assurances regarding outstanding obligations. Entirely apart from technical legal questions involved, it seems to us that practical considerations well support such fears. Although we do not raise a question as to the good faith of those at present giving assurances that there is no intention to tax outstanding obligations, we cannot be unaware of the fact that under stress, unexpected actions are frequently taken. Pressure on Congress that might be brought to bear at some later date because of a grave need for additional revenues, might create a temptation to reach into this field that would be difficult to resist. This is particularly true when it is realized that no effective opposition could be made as the States and their local units would no longer be directly affected.

Let us now direct our attention briefly to the economic arguments supporting such a change. John W. Hanes, Under Secretary of the Treasury, stated before this committee that—

the elimination of income-tax exemption is necessitated by three important considerations: (1) Effects on the distribution of the tax burden; (2) effects on the national economy; (3) effects on revenue and costs of Government.

The CHAIRMAN. It seems to me your fear as to the probability of the Congress in the future attempting to tax existing bonds was answered by Dr. Lutz's chart. I have been around here long enough to know that $100,000,000 is a very small amount with respect to the Federal Budget, and yet, that is approximately the amount he says the Federal Government would receive if it taxed all outstanding existing municipal and Federal bonds today, and while we may be a pretty bad outfit, and not stand by our word, I am inclined to think the temptation in this is not very great. So, I do not agree with your views on that. If it was a billion dollars, or something like that we might be tempted.

Mr. LINEN. Mr. Chairman, if we felt sure Dr. Lutz's figures were to be given full weight, our fears would be much less. They are very interesting and quite enlightening in the trade, and I learned a great deal from his report.

The CHAIRMAN. You may proceed.

Mr. LINEN. In regard to point No. 1, "Effects on the distribution of tax burden," I do not take issue. There are obviously inequalities possible, in the escape from tax made available, because of exempt

securities. It is surprising, in fact, that this method of excape is not used more than it is by individuals subject to the higher surtax levels. As Dr. Lutz has pointed out, reliable records over a period of 11 years (1926–36) have evidenced the fact that less than 10 percent on the average, of the investments of estates in excess of $1,000,000 were invested in State and municipal bonds. If one is successful in building a sizable fortune he is permitted to retain it and enjoy its benefits only for a time. If he wishes to give it away in part for other than charitable purposes in limited amounts, or if he dies, gift or estate taxes will quite effectively dissipate and disrupt the holdings, thus in effect appropriating a substantial part of the principal amount of the estate. It should be recognized also that in effect a tax is paid by the purchaser of State and municipal securities in the lower yield which he receives because of the exemption they enjoy. Such taxes constitute a penalty which makes temporary tax immunities, as far as the individual is concerned, much less vicious and such estate and gift taxes tend to modify the inequalities above referred to. It is largely in recognition of the fact that some inequities are possible that the Investment Bankers Association of America resolution which I have already read was supported. It is because we desire to avoid more grievous injustices that the constitutional method with proper safeguards is urged and the legislative method opposed.

Mr. Chairman, I might add too that we do not have any fear that Congress immediately is going to change that, but we do recognize the possibility, and which we think is something to be fearful of.

Senator BYRD. At that point, do you favor a constitutional amendment?

Mr. LINEN. With proper safeguard.

Senator BYRD. Your organization would advocate the passage of that amendment?

Mr. LINEN. The Investment Bankers Association has so advocated. Personally, if you ask me that question, I admit that Dr. Lutz's story has shaken my own confidence just as to the wisdom of that from an economical view.

"Effects on the national economy"—the argument has been advanced by various proponents of a change by legislative means that the effect of tax-exempt securities is to discourage in a serious way the investment of capital in enterprises involving risk. It is in effect admitted that there is no shortage of the supply of capital, Mr. Hanes stating that, "We are confronted today with a great surplus of capital which does not desire to take a chance, and a distinct shortage of that which does." It is further urged that because of the growing institutionalization of investment, it is the more important that investments by individuals be directed to the enterprise capital market if we are to give full employment to labor and increase the level of national well-being.

It is only proper that we should examine into the validity of these statements for they deal with important matters and we are all deeply concerned with those factors that have any direct influence on our national economy. Much the same argument was used in the early twenties when the late Congressman Louis T. McFadden of Pennsylvania, who sponsored a bill for the repeal of tax exemptions, said, "It is a matter of common knowledge that the diversion of the funds of wealthy estates and individuals from real-estate mortgages to tax-

exempt bonds has seriously handicapped the entire building program and industries of the country." We all know that following that period there was no serious lack of money to finance real-estate mortgages and building and industrial programs. Obviously, there is a choice between a type of investment that may enjoy tax-exempt benefits and a high degree of security as compared with one that involves a substantial risk of capital with corresponding profit possibilities.

First, it should be pointed out, however, that while many State and municipal bonds represent a high character of investment, tax exemption should not be generally accepted as eliminating risk—as much as municipal dealers would like to endorse such a theory. Second, it should be recognized that "investments in enterprise involving risk" which include the financing of new business projects, junior capital, etc., result on occasions, in substantial losses as well as profits. While there are, of course, funds that now seek exempt securities that might be released for risk enterprises if there were no exempt securities, it is my contention that exempt securities are not a major factor in this determination.

What then are the compelling factors in determining the character of risk to be assumed? The answer to this question should have an important bearing upon our so-called national economy. By this, I mean to include our employment of capital, our employment of labor and raising the level of our national well-being.

I would list as among the most compelling factors the following:

1. The probable net profit after paying taxes and other costs.
2. The need for a high degree of liquidity in the case of large estates due to inheritance tax schedules.
3. The uncertainties and costs of doing business due to (*a*) the attitude of Government toward business, (*b*) the attitude of labor, (*c*) the incidental costs involved in regard to the regulatory processes and required legal services.

As one contemplates the probable net profit after paying taxes and other costs, it is obvious when one examines the schedule of Federal income taxes applying in the upper brackets, that unless the investment opportunity is of that rare order where the promised return is high and the risk of capital practically nil, the investment is of questionable merit. Mr. Hanes has pointed out that if the tax applying at the level of a $500,000 taxable income is used, a man would net on his investment only 3 percent, on a return of 10.71 percent.

We all know that one cannot hope in these days for a return of 10 percent without incurring a substantial risk of capital. If the investor takes the risk successfully he would have a 3-percent net income. If the risk went against him, the Government would not make good the loss. In other words, the game is pretty much—the Government wins, the investor loses.

Is not the real answer this, as long as the Government takes practically all the profit when there is a profit, the chances are simply too heavy against a man with a substantial income to justify investing in what are referred to as risk enterprises. As a matter of information it is interesting to note that in New York State the combined Federal and State income taxes require individuals in the top income brackets to pay 87 percent of their income falling within such brackets. In the case of a net taxable income of $1,000,000 the combined tax

would equal 75.8 percent of the total income. Is not all incentive to investment in new enterprises discouraged at this point? This is unfortunate, for the man of substantial means is the one who can best afford under normal circumstances to risk capital in new exemption, or at the Government which imposes such a tax? Even if there were no tax-exempt securities such an individual could not afford to invest in other than riskless securities.

There is attached a schedule showing the levels of tax on incomes by the Federal Government under the Revenue Acts of 1921, 1924, 1926, 1928, and 1938. It is to be noted that the combined normal and surtax levies in the highest brackets for the years 1925 to 1931, inclusive, were 25 percent as compared with the Revenue Act of 1938 which exacts a combined levy of 79 percent.

May I add that the probability that State income would be easily sufficient to compensate for the high interest cost is certainly doubtful to the extent that the Government has already appropriated this field of taxation.

Mr. LINEN. Some progress has been made in that without question.

The inheritance tax is a matter also of grave concern to people who might under other circumstances invest in productive ventures. A situation came to my attention only a few days ago where a man whose estate is worth about $30,000,000 is in a dilemma as to how best to employ his idle capital. He has financed a variety of ventures in times past, but under present tax laws this is out of the question. He estimates in the event of his death his estate will face a tax of $19,600,000. If anything is to be realized by his heirs, it is essential that his estate be highly liquid. At present he is holding about $10,000,000 in cash and I am told he holds practically no State or municipal securities. It can certainly not be contended that tax-exempt securities are responsible for his not being willing to risk his capital.

The CHAIRMAN. We tried to correct that situation in the last revenue bill. We extended the period to 10 years, and reduced the interest to 4 percent so there would not be such a high degree of liquidity.

Much has been said about current uncertainties and the present-day cost of doing business. I do not believe I need add much to the comments I have already made in outline form.

We all know that business has had to try and adjust itself to a veritable bombardment of changes in the relation of government to agriculture, to industry, and to finance. These changes have been too numerous and too drastic for the good of our national welfare as it has been impossible to make the necessary adjustments within such a short space of time and continue to develop new enterprises. Lawyers must be consulted at every turn and caution and doubt reign in the place of enterprise and progressive creativeness.

Without any desire to revive a controversial question, I would simply mention the Supreme Court issue as a case in point. The country spent many months in considering this issue which raised the gravest fears and shook the confidence of both investors and business to a great degree.

If Congress should pass a bill purporting to permit the Federal Government to tax income derived from State and municipal securities, but providing that such permission should apply only to future

issues, and should the Court uphold the right of Congress to legislate at its will, on the subject of taxing in this manner the sovereign States and their political subdivisions, there would be marked alarm as to the possibility of future developments. There would be doubt also regarding the reciprocal arrangement proposed whereby the Federal Government would grant to the States and their political subdivisions the right to tax the income on Federal securities because of the right which the Federal Government would assert to tax the income from State and municipal securities. As it is a settled constitutional principle that no legislature can bind its successors, what assurance is there: (1) That Congress might not withdraw the right to the States to tax the income on Federal securities. (It is interesting to note in this connection that Assistant Attorney General Morris in his letter of transmittal to the Treasury Department under date of June 24, 1938, cited, "That ordinarily tax immunity is a privilege of Federal, not of State, instrumentalities.") (2) That Congress would not pass legislation taxing outstanding as well as future issues of State and municipal securities. (3) That Congress would not attempt to interpret this further grant of power as authority to tax the revenue of States and their political subdivisions.

While we all may agree that it is not reasonable to assume that Congress would take such action, these possibilities must be recognized as must also the possible effect upon the public confidence.

Such matters have an important relation to our national economy and I do not believe I overstate the fact when I assert that a determined effort by the Congress to eliminate tax immunities of future issues of State and municipal bonds by a legislative act instead of following the constitutional procedure, will again disturb and greatly concern a large body of our citizens. If the constitutional method were attempted, we would not be trying to override court decisions by an act of Congress. We would not be trying to compel the courts to reverse a long standing judicial tradition as is urged in the special study made by the Department of Justice in the following language:

> The value of an affirmative direction by Congress, of course, lies in the fact that the tax would be supported by the full weight of the presumption of constitutionality which attaches to an act of Congress.

The only objections that can be reasonably urged against the constitutional procedure, it seems to me, are: (1) That the influence of State officials would be sufficient to prevent such an amendment passing, (2) that there is some emergency that calls for prompt action.

In reference to the first point, it is possible an amendment proposed by the Congress and referred to the State legislatures might meet with substantial opposition. It would seem, however, that the possibility of defeat is an odd reason for resisting the submission of a constitutional amendment to the people. The people in this way would have a fair chance to indicate what they want to do about it.

In reference to an existing emergency, I do not understand that the Federal Government is claiming any emergency in connection with its immediate fiscal needs. It is proposing to tax only future issues of State and municipal bonds and not existing tax-exempt securities. It is admitted that substantial revenues cannot be reasonably anticipated from this source in the early future. Thus, the only ground on which an emergency can be claimed is the one with which I have already

dealt rather fully; namely, the argument that the existence of tax-exempt securities is resulting in an inadequate supply of capital being available in the business field because men of large wealth are by preference buying tax-exempt securities. The arguments supporting this thesis are not convincing. There is no emergency so far as the national economy is concerned growing out of the existence of tax-exempt securities.

I believe that this special committee could not make a greater contribution to the restoration of business confidence and investor confidence in the United States in rejecting the proposed statutory method of dealing with this subject. If it is to be considered at all a constitutional amendment would seem to be the only proper approach.

As Dr. Lutz has already dealt very fully with Mr. Hane's third point; namely, "Effects of revenues and costs of Government," I will not attempt to further expand this subject beyond saying that I am familiar with the study and I consider the conclusions are reasonable and well supported by the arguments and facts presented. I consider his study a highly intelligent and valuable contribution to this important subject. I commend it to those who wish better to understand the probable practical effects of a change, such as is proposed.

Senator MILLER. Mr. Linen, you have made a very interesting statement, but the apprehension you may have that the State governments themselves might tax past issuances of their own securities, of course, is not well-founded, as everybody knows, because the States cannot legislate in matters as to impairing a contract. That is as to State issues, and the due-process clause of the fifth amendment of the Constitution would certainly prevent any Congress from passing legislation to tax past issues of Federal securities. I do not believe that apprehension is well-founded at all. I understand the apprehension business, but, there is no use to set up a straw man and knock him down.

Mr. LINEN. It has always been my understanding that the enjoyment of exemption as to State and Federal securities is not because of any particular relation of the Federal Government and the States, but simply because the power is not recognized, and the tax has not been levied.

Senator MILLER. But, you must not overlook the due-process clause of the Constitution.

Mr. LINEN. Where the State would impose the tax. Of course, the Federal issue is so much higher than the State issue. That is the major factor.

The CHAIRMAN. Any questions of Mr. Linen?

(No response.)

The CHAIRMAN. Thank you, Mr. Linen.

We will now call on Mr. Patrick Healy, executive secretary of the North Carolina League of Municipalities.

STATEMENT OF PATRICK HEALY, JR., EXECUTIVE SECRETARY OF THE NORTH CAROLINA LEAGUE OF MUNICIPALITIES

Mr. HEALY. Mr. Chairman and gentlemen of the committee: The North Carolina League of Municipalities, a fact-finding agency and clearing house of information on municipal affairs established by municipalities in 1909 and maintained at present by 171 active

member cities and towns throughout the State, urges disapproval of the proposal that the issuance of State and local governmental securities be subject to income taxes unless the States' consent should first be obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities in the States and including an absolute prohibition against any Federal taxation of the revenues of the States and municipalities. The League also urges that legislation should be passed at this session of Congress limiting any taxation of State officers and employees to salaries which they receive in the future. The league's position on these matters is set forth in a resolution unanimously adopted at its annual convention, August 6, 1938:

Whereas the Supreme Court of the United States in the recent decision in *Helvering* v. *Gerhardt* rejected the reciprocal test of tax immunity and returned to Chief Justice Marshall's understanding that the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the Central Government; and

Whereas employees of municipalities are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926; and

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal bonds as well as future municipal bond issues; and

Whereas the Federal Government claims the power to impose the Federal corporate income tax on the revenues of State and municipal agencies, such as power and lights, toll bridges, water supply, and other revenue-producing functions: Now, therefore, be it

Resolved, By the North Carolina League of Municipalities in convention assembled at Asheville, N. C., this 6th day of August 1938, that if State securities are to be taxed by the Federal Government, the States' consent should first be obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities in the State and including an absolute prohibition against any Federal taxation of the revenues of the State and municipalities or of State and municipal agencies; and be it further

Resolved, That congressional legislation should be passed at the next session of Congress limiting any taxation of State officers and employees to salaries which they receive in the future; and be it further

Resolved, That copies of this resolution be sent to North Carolina Senators and Representatives in Congress, and to the Conference on State Defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

Because of the growing number of conflicts occurring between the local, State, and Federal systems, the North Carolina League of Municipalities strongly urges the appointment of a group representing all interested parties to determine what relationships should exist between the three levels of government. State and Federal conflicts in tax systems increased from 323 to 800 cases in the 2 years from 1931 to 1933. State control over local affairs has been increasing and in some cases certain functions, elsewhere performed locally, are being transferred to the State. Likewise, it has been proposed that the Federal Government support certain State and local functions other than "emergency" welfare activities, which have more than a State-wide interest.

Such changes are usually ignored or overlooked. Yet, these very shifts of relationships between the three levels of government may ultimately change the structure of our government itself. Certainly, these changing relationships should be examined and the trends observed. On the basis of such understanding at least the most desirable relationships could be identified. Then the activities and

revenues of local, State, and Federal Governments could be shaped to develop those relationships. Such a study might best be made by a group or committee representing all interested parties, including local government, the States, the Federal Government, the taxpayers, civic groups, and others.

Certainly the proposal to subject the income from governmental securities to Federal and State income taxes is one important matter that should be carefully studied by such a group. Too little is known about the effects that such a tax would have to warrant its imposition without further careful study. On one point, however, there is fairly general agreement, namely, that the effect of a tax on the income from a class of public securities which the investing public has long regarded as nontaxable would be an adjustment of price and yield basis that would represent an effort by the investors to recover part of all of the tax from the debtor governments. Insofar as this effort is successful, the result is that the debtor governments will pay more for the funds which they borrow, after the tax and as a consequence of its imposition, than they would have to pay had there been no tax. No positive figure can be named as to the amount of increased interest rate which will result from subjecting governmental securities to income taxes, although many prominent authorities agree that as to long-term borrowings the increased cost will be between 50 and 100 points, while the increased cost of short-term borrowings will be between 15 and 30 points. The percentage increase will undoubtedly be larger as to the weaker units of government.

On June 30, 1938, the total State and local government debt in North Carolina was $515,900,888, made up as follows:

State	$161, 934, 000
City	158, 755, 478
County	147, 700, 245
District	22, 551, 164
Floating debt, miscellaneous, estimated	25, 000, 000

It will be observed that approximately two-thirds of this total debt belongs to local governments. While reciprocal taxation might result in the State government getting back part or all of the increased cost of borrowing, this would certainly not be true as to local governments, for the latter levy no income tax, nor do they share in the State-levied income tax. State assumption of school costs in North Carolina is made possible by the imposition of a 3-percent State sales tax, and State assumption of the cost of maintaining State and county roads is made possible by a State levy of a 6-cent-per-gallon gasoline tax. One-half the State's cost of social security is met by the imposition of county property taxes. Thus it is seen that the State income tax is neither shared directly in North Carolina with local governments, nor indirectly by assuming local government functions paid for by State income taxes, which are now considered as high as they should go. The only result of the suggested taxation of governmental securities would be increased cost of borrowing money on the part of municipalities and counties, and the taxes now levied on property in North Carolina by counties, cities, and other local taxing units to meet the interest requirements on their outstanding bonds represent 49.1 percent of their total tax levies.

It is apparent that this tax burden ought not to be increased by adding to the cost of borrowings of local governments by increasing

interest rates which will have to be paid by them. It is safe to say that any such action by Congress imposing a Federal income tax which will actually be paid by local property taxpayers will not be appreciated by the latter.

Finally, if we should depart from the time-honored doctrine of immunity of taxation in our system of government, many other problems of intergovernment taxation will be raised. For example, the Federal Government might on the same principle tax the incomes of municipally owned water plants or power plants, toll bridges, and other revenue-producing functions, while the local governments might tax federally owned lands which are not used as essential activities of the Federal Government.

In summary, therefore, the North Carolina League of Municipalities takes the position: (1) That the increased interest rate which would result from a Federal tax on State and municipal securities would add an extra burden upon local governments and taxpayers which will not be offset by reciprocal taxation by the States of Federal securities; (2) that a departure from the doctrine of immunity of taxation will result in the raising of many problems of intergovernment taxation; (3) that if State and local government securities are to be taxed by the Federal Government, the States' consent should first be obtained through a constitutional amendment permitting reciprocal taxation of Federal securities by the States and including an absolute prohibition against any Federal taxation of the revenues of States and municipalities or their agencies; and (4) that the conflicting taxation and changing relationships between the Federal, State, and local governments should be thoroughly studied by a group or committee representing all interested parties.

The CHAIRMAN. We thank you, Mr. Healy.

Senator BYRD. You state now that the tax levied on North Carolina property to meet interest outlay represents 49.1 of their total tax levy. Is not that rather unusual?

Mr. HEALY. Yes, it is. They have rather a high debt that they incurred down there in the twenties, and they have had a great many defaulting towns and cities and counties, and they have tried and they are trying gradually to work out this difficulty.

Senator BYRD. There has been some reduction of that?

Mr. HEALY. Yes, sir; the debt is gradually being reduced. We have local governments that are helping us to work out this difficulty.

Senator TOWNSEND. Most of your borrowings are for roads?

Mr. HEALY. No; the State borrowed $115,000,000 for roads. The State has had no financial difficulties. The chief difficulties, I think, have had to do with the special-assessment bonds.

The CHAIRMAN. That is what you referred to here as district bonds, $22,000,000?

Mr. HEALY. No; that represents school districts.

The CHAIRMAN. Any other questions of Mr. Healy? Thank you, Mr. Healy.

STATEMENT OF F. BURT FERNHOFF, CITY ATTORNEY OF OAKLAND, CALIF., APPEARING ON BEHALF OF THE CALIFORNIA LEAGUE OF MUNICIPALITIES

Mr. FERNHOFF. Mr. Chairman and gentlemen of the committee, you have heard some loud moaning and wailing from the Atlantic coast. I want to bring you a big growl from the California bear and all of the little bears.

Gentlemen, I am here on behalf of the municipalities of California. The California League of Municipalities, on whose behalf I appear, is composed of 258 municipalities out of a total of 285 of the incorporated cities of the State.

Just as soon as it was brought to our attention that the Treasury Department proposed to tax our future securities, we took immediate steps to register the opposition of California cities and towns before this committee.

The municipalities of California adopted a resolution which says:

Whereas certain departments of the Federal Government are asserting the supreme power in the Federal Government to tax States without their consent and at the same time denying any reciprocal right of the States to tax bonds, agencies, and employees of the Federal Government; and

Whereas the Department of Justice has set forth in a report to the Treasury Department that the Federal Government has the power to levy an income tax on the revenues of the States, and agencies of the States and municipalities, and also in said report it is claimed that bonds of the States and State agencies heretofore issued or to be issued, and salaries of the employees of the States and municipalities, are subject to Federal income levies; and

Whereas it is the sense of the League of California Municipalities that any attempt on the part of the Federal Government to accomplish these purposes by an act of Congress is an attack on the sovereignty of the States and in violation of both the spirit and the letter of the Federal Constitution: Now, therefore, be it

Resolved, 1. The league contends that the revenues of public enterprises carried on by the State and local governments, whether they be essential governmental functions or not, must continue to be exempt from Federal tax just as we believe the revenues of the Federal Government should be exempt from taxation by the State and local governments.

2. The league recommends the passage of Federal legislation to prohibit the application to public employees of any retroactive assessments and penalties in connection with the payment of Federal income tax, in the event public employees should later be required to pay Federal income tax.

3. The league opposes any attempt to extend the Federal income tax to the salaries of State and local employees or to the interest paid on State and local bonds unless and until the consent of the States shall first have been obtained through an amendment to the Federal Constitution.

4. Any proposed amendment to the Constitution to make the interest on State and local bonds subject to the Federal income tax should provide for State and local taxation of Federal bonds on the same legal basis, but in both cases the application of these taxes to outstanding bond obligations should be prohibited.

5. Any proposed amendment to the Constitution to extend the Federal income tax to State and local employees should provide the same legal basis for the extension of State income taxes to Federal employees.

6. The president of the league is requested to appoint a committee to confer with State, county, and district offices to map out a plan to accomplish the objectives outlined above.

In dollars and cents the proposal to tax our cities will impose a crushing burden on our fiscal systems. Even on the basis of the estimate made by the Treasury Department, that interest rates would increase up to one-half of 1 percent if their immunity is ended, California State and municipal governments would be compelled to pay approximately $7,250,000 to $8,000,000 a year in additional financing charges. If we calculate on the basis of the estimate made for Comp-

troller Tremaine by Professor Lutz and assume that interest rates will go up only six-tenths of one percent, California Government will be compelled to shoulder about $9,100,000 additional cost every year.

Since the formation of the special committee on taxation on the California League of Municipalities, I have had occasion to discuss the effects of this tax proposal with the fiscal officers of many of the municipalities throughout my State.

On the basis of those talks, I should say, however, that the estimates submitted here are very conservative. The buyers would, of course, discount the bonds, not only against the present tax rates, but also against their own fears as to future increases in those rates. If anything, the estimates given err on the side of underestimating the additional expense to local government.

Of the added cost to the State of California, 85 percent would be borne by the municipalities and other subdivisions whom I represent.

We have a peculiar situation in California, where most of the indebtedness is owed by the municipalities and city governments, and very little by the State.

From my knowledge of the financial condition of municipal governments of my State, I am able to state that we simply cannot stand this terrific increase in the cost of our government. We will have to choose between two almost equally impossible choices. We might absorb the tax and try to pass it on in the form of higher real-estate taxes. But the committee knows the plight of the real-estate holder in this country without my elaborating it. In California, as well as in any other State of the Union, real estate is already burdened with an almost unbearable share of the cost of Government. More likely than not, if we should try to raise real-estate taxes, the California municipalities would become the greatest holders of real estate in the country. There is a limit beyond which the real-estate taxpayer cannot be pushed. At a certain point, he will throw up his hands and tell us to take over his property.

We would have only one other alternative under this proposal. If we cannot increase our real-estate taxes, we will simply have to cut down on our governmental functions—which would mean cutting down on the money which we have to spend for our schools, for our streets, for our policing, for our fire protection, for relief, for our hospitals, and for all the other necessary functions of local government.

The functions of government are many and varied. They have been divided between the municipalities, the States, and the Federal Government. Each of these governments performs important services. But I have no hesitation in saying that those which most intimately concern the daily life of the people of this country are performed by the municipalities. The Federal Government makes us a nation. But municipal government was the first form of government in organized society. We, in California, can see no reason why the alleged needs of the Federal Government should be put before the equally pressing needs of our municipalities.

I should like also to treat the proposal to allow reciprocal taxation of Federal securities. From the point of view of the municipalities in California, or in any other State, that proposal means nothing whatever. It would do our municipalities no good at all if their State government may tax Federal securities. We have no power to levy any income tax. And it should be remembered that 85 percent of California's total added cost from the taxation of its securities would

be borne by the municipalities. In other words, our municipalities would pay up to $10,000,000 a year to the Federal Treasury and not get a penny in return.

The CHAIRMAN. What is your State debt out there?

Mr. FERNHOFF. I could not tell you the amount of the State debt, Senator. You see, we finance our roads with a fairly large gas tax, but most of the public works have been carried on by the municipalities.

Senator TOWNSEND. What is the debt of your municipality?

Mr. FERNHOFF. I haven't got those figures here, but I understand it is about a billion and a half dollars.

Even from the point of view of our State government, California is threatened with an impossible financial situation if the Federal Government insists on taxing its securities. Suppose, we should have to take up our entire $10,000,000 loss by increased income taxes. On the basis of our 1936 rates, we would then actually have to raise our income tax rates by 42.2 percent. In other words, our total income tax collections in California in 1936 amounted to $21,515,000 and the added cost which the taxation of our securities would impose would be at least $9,096,000. That is to say, for every dollar of income tax which we receive at the present time we would have to receive $1.42 to keep our fiscal balance.

As a financial proposition, therefore, from the point of view of the State and municipal governments, elimination of their immunity would create a disruption of their fiscal systems which would threaten municipal bankruptcy in many cases. In fact I am tempted by curiosity to speculate as to whether or not the recent Municipal Bankruptcy Act wasn't passed as a necessary preparation for the present proposal to end immunity.

There is another argument of the Treasury Department against which I must protest. It is said that tax immunity has encouraged State and local extravagance.

It is possible to find in our history periods of State and municipal financing in which abuses were committed in the issue of public securities. However, in the light of present day Federal expenditures our present municipal expenditures appear modest. During the last 25 years there has been an increasing regard for proper standards and increasingly strict control by legislation and by administrative agencies over the purposes and amounts of the debt that could be issued. But the best test of the need and the usefulness of our outstanding State and local debt is made by examining the purposes for which we have borrowed. Our local money has largely gone into public buildings, parks, hospitals, schools, highways, and the like.

We are satisfied that there is no desire to curtail expenditures in these vital fields. And so those who charge municipal extravagance are either largely ignorant of the expenses of local government or oppose public expenditure for functions such as education, health, and highways. At a time when our schools are overcrowded, when we need more hospitals and more public health service, when our cities need more parks for our children to play in, when we need better streets to save human life—at such a time, I say, it is strange that there is offered as one of the virtues of this plan, the argument that ending immunity will make it harder for local governments to finance these necessary activities.

On behalf of the municipalities of California, we submit that this proposal to tax our obligations is a grave threat to our government.

If there is any purpose to tax us, we submit that the consent of the States should be sought by a constitutional amendment. Let the country have the benefit of the debate which such a proposal will cause. We believe that the intrinsic economic weaknesses of the proposal will, on such debate, terminate the issue for all time.

The CHAIRMAN. Any questions of Mr. Fernhoff?

(No answer.)

The CHAIRMAN. Thank you very much, Mr. Fernhoff.

STATEMENT OF NORMAN A. PEIL, DIRECTOR OF ACCOUNTS AND FINANCE, EASTON, PA.

Mr. PEIL. Mr. Chairman and gentlemen of the committee, if the committee please, I am appearing not only in my official capacity as director of accounts and finance of the city of Easton, Pa., but also as the representative of the Pennsylvania League of Third Class Cities, comprising 44 cities in my State.

As for my experience in the field of finance, I am an accountant by profession. I was the secretary of Galvanized Products Co., 1919 to 1926, and thus acquired experience in corporate finance. I took public office in 1932 as director of public safety. In this capacity I planned and refunded a $470,000 issue of city of Easton bonds, affecting a net savings in interest rate of $113,500 over the life of the bonds.

I planned and executed the financing of the acquisition for the city of two privately owned waterworks which involved $3,850,000, and planned and executed several other refunding operations for the city of Easton, materially reducing the interest charges to the community, which directly resulted in a reduction of 1½ mills in the tax rate. I am chairman of the League Activities Committee of the League of Third Class Cities of Pennsylvania, and a member of the executive board of the Municipal Finance Officers' Association of the United States and Canada. I was reelected to public office in 1935, now serving the city of Easton as director of accounts and finance.

I am opposed to the Federal Government taxing State and municipal bonds since a careful study convinces me that the proposal cannot bring in more revenue without increasing the cost of State and local government far out of proportion to the revenue gained.

Of the very many municipal officials and finance officers that I have talked to on this question, I have yet to find many who feel that the Federal Government ought to tax State and municipal obligations. The Pennsylvania League of Third Class Cities, and municipal leagues and other organizations throughout the country have adopted resolutions condemning the Treasury's proposal. It seems to me that those who are for the legislation are for it because of arbitrary reasons or because they have not analyzed the effect of such legislation.

Mr. John W. Hanes, Under Secretary of the Treasury, in the last paragraph on page 3 of his statement, claims that—

> elimination of income-tax exemption is necessitated by three important considerations; first, effects on the distribution of the tax burden; second, effects on the national economy.

This raises a doubt in my mind as to just what the objective of this proposed legislation is. Is it being considered as a basis for additional revenues or is it being considered for the purpose of making governmental securities less attractive so as to divert capital to in-

dustrial fields? If the latter is the real, sincere objective, then I merely want to state that, in my humble opinion, taxation of State and municipal bonds will not help business, but will hurt it.

On page 6 of the Under Secretary's report he claims that the outstanding amount of tax-exempt securities is greatly in excess of the demand for such securities on the part of individuals who are subject to the high income-tax rates. If this is a fact then I cannot understand why we should attempt to tax these securities. This, it seems to me, would make the securities undesirable to the investor and appreciably increase the cost of finance to the State and local government.

The Under Secretary of the Treasury further claims that in consequence, substantial proportions of such securities have to be disposed of to institutional investors and to individuals to whom the tax-exempt privilege has little or no value. This being the case, placing a tax on the governmental securities would merely mean a larger income to this particular class without appreciably increasing the revenues to the Federal Government.

Moreover, in extending an example of the tax liability of a man with a net income of $500,000 as compared to a man with a net income of $5,000, the Under Secretary assumes the hypothesis of an individual owning almost $17,000,000 of tax-exempt securities. While I have no way of determining how many such individuals there may be in the United States, I am certain there are few indeed.

On page 6 of the Under Secretary's statement he refers to table 3 which is attached to his statement and which tends to show how tax-exempt securities of all governmental instrumentalities are distributed among the various investing groups in the country. This table shows that there are 65.6 billions of dollars in exempt securities now outstanding but that only 19.3 billions of this total have been issued by the State and local governments. In other words 70 percent of the total outstanding tax-exempt securities have been issued by the Federal Government. Of the total of 19.3 billions of dollars which have been issued by State and local governments only 8.3 billions of dollars are in the hands of individuals. With this relatively small amount of the total being issued by the State and local government, which are in the hands of individuals, it seems to me that the Federal Government might better attempt to tax their own securities and forget about State and local securities.

In my State and city, and I believe this is fairly representative of the majority of the cities and States, the problem of governmental costs has been a tremendous one for us ever since 1930. We must consider the fact that local government is supported largely by real estate. In the city of Easton real estate pays 80 percent of the cost of government, and any increase in local government cost must come from this source. We have been paring expenses and doing everything that is humanly possible to bring down local government costs and thereby reduce taxes in an effort to reestablish confidence in real estate. In my opinion it is manifestly unfair for the Federal Government to do anything whatsoever that will tend to increase the cost of local government and, thereby, indirectly increase the cost of owning real estate. If the Federal Government wants to experiment in the abolition of tax-exempt securities it could do so with its own issues to see what the result will be, before attempting to extend this authority over State and municipal obligations.

When a tax law is proposed where the object is to tax revenues that are not being reached by present legislation one of the first questions that I ask myself is this: "Can this tax be passed on to someone else by the one who originally pays the tax?" In putting this question to the proposed legislation the answer is decidedly "yes" and I would like to cite a specific example in my own experience in my city to demonstrate this point. In 1933, when I first entered the council of the City of Easton, they had $470,000 of sewer-assessment bonds on which they were paying 6-percent interest. Due to the fact that the interest was not being paid in sufficient volume by the owners of property against which the assessments were levied, it was necessary to use principal monies to meet the coupons when they were presented for payment. This automatically created a deficit which annually increased. In 1932 this deficit had reached the sum of $65,000 and it did not require much calculation to determine the deficit would run to $113,500 before the bonds could be paid off. This would have been an obligation which the taxpayers of Easton would have had to assume and for this reason we planned a refunding of these obligations which had the callable feature written in them. We recited in the bonds that they were taxable obligations. The result was that on the day set to open bids we received none! Later we sold them on a 4-percent basis.

In Pennsylvania we have a 4 mills tax on municipal indebtedness and this was the tax that I was attempting to pass on to the holders of the bonds. What happened was that we paid 1 percent more for our money than we would have had to pay had we sold tax-free bonds. The net result was that while we attempted to save the 4 mills tax on this issue, we were penalized an additional 10 mills in the interest rate that we had to pay for the money, so that the increased cost to the city was two and one-half times what we were attempting to save.

The CHAIRMAN. Have you any comparative cases on which to base that result, Mr. Peil? As you know, 1932 was a mighty difficult time.

Mr. PEIL. That should be 1933. We sold them in 1933. We had to sell them at a private sale, for we had no alternative, for we had called in those 6-percent bonds, and we had to have the money, and we had to get the money to pay off the bonds which we had called, and that was the best price that we could get. Some of the bonds have been refunded as low as one and one-half off, and others have sold down to three and one-eighth.

The CHAIRMAN. You were paying 6 percent for your money?

Mr. PEIL. These were special assessment bonds.

The CHAIRMAN. Were they tax exempt?

Mr. PEIL. Yes; they were tax exempt, for I am having a fight on that now, as to who had to pay that tax. The dealer had not paid that, and now they are trying to assess that cost on the city of Easton. I think it is their duty to collect it from the bondholders.

As to the figures I have, my authority for that statement, gentlemen, is this: Take the bondholders' index in 1933. At the time we sold the bonds, the average was 4 percent. We had to pay 4 percent on all of our other issues we have sold since then, and now. We were at least within 1 percent of the average. For example, let me state that we refunded a portion of this in August 1934. Then the average, according to the Bond Buyer was 4.05. Our coupon rate was 3½, and when you take into consideration the figure we received, it brought

it down to 3.05. The bond people had to sell these bonds through the industry at a less rate, so the investor did not get 3.05 on that deal.

The next is this deal in 1935. We had another deal then. They were general refunding bonds. The average was 3¾. The price was 2.04, and the premium brought it down to 2.02, and in financing later issues, the average in 1936 was 3.25.

We had to buy our waterworks, and we paid $1,100,000 cost price, and 2.50 was the price of the bonds, and we got a $10,000 premium, which brought the yield down to 3.20.

You will admit that we were getting into a better bond market at that time than in 1932 and 1933. This shows the interest that we paid, as compared to the bondholders' index. I am merely comparing what the city has accomplished.

The CHAIRMAN. How do you account for the 4-mill tax?

Mr. PEIL. I will cover that a little later. I will be glad to answer that when I have finished.

The CHAIRMAN. That will be satisfactory.

Mr. PEIL. Another recent case in Pennsylvania was that of the school district of Lewiston. As a result of the newspaper articles on the proposal by the Federal Government to tax State and local bonds, the Lewiston school board determined to sell the bonds on a taxable basis. When the time arrived for the board to open bids, there were none to be opened. Several representatives of the bond houses were there to see what bids were received, and, when none were received, the board, of course, began to question the representatives. The answer in all cases was, "How could bidders determine a price for the bonds when there was no way of knowing what taxes would be levied next year, or in 5 years, or in 10 years?" Under such circumstances, no one is in a position to make an intelligent offer for the bonds and, as a result, bids are apt to be far lower than they would ordinarily in order to discount possible future increases in the tax rate.

I would like to add that practical experience in Pennsylvania has proved that a tax on municipal bonds is worthless. As a result of 2 years of fighting on the part of the local officials of Pennsylvania, the legislature will vote this year on a bill to repeal the 4-mill tax on municipal indebtedness, and I am happy to say that we have found much sentiment, not only among the people of our State, but also among the legislators in favor of the repeal of this tax.

The CHAIRMAN. Why would not that argument be practically the same as to bonds of the United States Steel Corporation?

Mr. PEIL. That, of course, is true, Senator, and that to that extent would really bring up Federal and municipal securities to the same level.

One other point I would like to raise before I conclude my statement. That has to do with the recent announcement of the President of his desire to create a permanent Public Works Board to carry on a public-works program as a relief measure. With local governments striving to reduce their costs, and at the same time being willing and ready to cooperate with the Federal Government in a public-works program, at considerable expense, it seems unreasonable to me that the Federal Government should do anything that would further increase the cost of local government by placing a tax on their securities, and, thereby, compelling them to pay higher financing charges.

I am submitting herewith a copy of a resolution which was passed by the League of Third-Class Cities of Pennsylvania at their conven-

tion assembled in Reading, Pa., on August 31, September 1 and 2, 1938. This resolution clearly expresses the attitude of the third-class cities of Pennsylvania as being opposed to a Federal tax on State and municipal securities [reading]:

Resolution presented to the thirty-ninth annual convention of the League of Cities of the Third Class in Pennsylvania held at Reading, Pa., Sept. 1 and 2, 1938.

Continuing efforts are now being made in the United States to subject to Federal taxation the income from State and municipal bonds, the salaries of State and local employees, and in some cases the revenues of public bodies. The stated purpose of such taxation is to increase the revenues of the National Government. There have been some intimations that the taxation of public salaries might even be made retroactive for certain groups of employees.

The convention condemns any attempt to make retroactive any ruling which would permit the collection of income taxes on the salaries of any group of public employees theretofore considered exempt. Such a policy would be a punitive measure unduly penalizing a group which has acted in good faith. Nor should any attempt be made to tax the income on State and local securities already outstanding.

In the interest of equity in taxation the convention is not opposed to taxation of the salaries of State and local employees by the Federal Government provided that the Federal Government at the same time permits the taxation of Federal employees by States having State income-tax laws.

While the convention is opposed to the Federal taxation of the income from State and municipal bonds already outstanding because such a measure would seem unfair to the present holders thereof, it opposes the taxation of State and municipal bonds to be issued in the future on a different basis. The net result of such taxation would be an increase generally in the cost of local government with a corresponding increase in Federal revenues. This tends toward a greater centralization of revenues in the Federal Government with a consequent increase in the revenue difficulties of the local governments.

Furthermore, the convention is opposed to the taxation of revenues or income of public bodies properly organized as such whether they are performing services generally classified as governmental functions or whether they are performing so-called proprietary activities.

The convention believes that the chief issues involved in the new types of taxation are the further centralization of power in the Federal Government and the consequent weakening of local governments and, therefore, believes that the discussion should be viewed in that light.

This convention condemns any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities, and any attempt to tax State or municipal bonds, or the salaries of State and local governmental employees, unless and until the consent of the States is first obtained through a proper constitutional amendment.

The CHAIRMAN. Now you will answer my question about how you impose that 4-mill tax?

Mr. PEIL. Yes, sir.

The 4-mill tax on municipal indebtedness is parallel to the 4-mill corporation loan tax. We have had the 4-mill tax since 1913. They raised the municipal loan tax to parallel the corporation loan tax, so that municipal and corporation bonds would be on the same level.

In 1935 the legislature raised that to 8 mills, but, by ruling of the attorney general, it was not applicable to municipal bonds, and only to corporate securities, and, therefore, we have to pay the 4 mills.

The CHAIRMAN. Who pays that?

Mr. PEIL. As a matter of convenience, since we have always put in the bonds that they are tax-free, we have paid the tax, because the law makes it incumbent upon the issuer of the bonds to collect the tax on the bonds at the time the interest is paid. So, whether the man paid it tax-free and got a lower rate, or the bond was taxable at a higher rate, we turn in the money to the State.

The CHAIRMAN. In other words, the State of Pennsylvania has imposed a 4-mill tax on interest on these bonds?

Mr. PEIL. Yes, sir.

The CHAIRMAN. Which the municipality bears, and they have a 4-mill tax on all forms of securities, including municipal bonds?

Mr. PEIL. Yes, sir; and we are going to repeal that this year. I firmly believe that that will be repealed. There is so much sentiment among the people of Pennsylvania that those who are striving to have it repealed think that it will be repealed.

The CHAIRMAN. How many years has it been on the statute books?

Mr. PEIL. Twenty-five years.

Senator MILLER. Is that tax on the principal or on the interest?

Mr. PEIL. It is a personal-property tax. It was designed as an aid to the real-estate property tax. You see, in Pennsylvania, real estate bears too much of the tax.

Senator MILLER. Are you going to try to repeal the tax on the bonds all of the way through?

Mr. PEIL. No; just the municipal indebtedness.

Senator TOWNSEND. Do you know what the income amounted to?

Mr. PEIL. Yes, sir. The State of Pennsylvania collects 2½ million dollars on that.

Senator BYRD. Not municipal indebtedness?

Mr. PEIL. Yes, sir.

The CHAIRMAN. What are you going to replace that with?

Mr. PEIL. They are going to reduce the cost of Government. It is not to be replaced.

The CHAIRMAN. Is that an annual tax?

Mr. PEIL. Yes, sir. It must be paid on the 15th of March.

The CHAIRMAN. So, if the city of Easton issued a bond of 2½ percent, it pays 4 mills, which would make it cost the city 2.9 per year.

Mr. PEIL. Yes, sir.

The only exemption that we get from that is where the bonds are held outside of the State of Pennsylvania. Then we do not have to pay the tax, and if they are held by charitable institutions, or the retirement fund, who have a tremendous lot of our bonds. For instance, out of a total indebtedness of $2,600,000 outstanding, we only pay about $7,000 a year in tax, for the rest of the bonds are held by tax-exempt institutions.

The CHAIRMAN. I am particularly interested in that, for it seems somewhat similar to the proposal we have before us. It works out practically the same way.

Mr. PEIL. It was a practical matter for the city to absorb the tax. We tried to pass it along, once, and got burnt. We had our lesson, and we have not tried it since then.

Of course, they were always arguing that it was a tax on personal property. We have to collect it, as the issuing political entity.

The CHAIRMAN. You have a general property tax in Pennsylvania?

Mr. PEIL. For local purposes only.

The CHAIRMAN. That includes personal property?

Mr. PEIL. The personal property tax goes to the county and State.

The CHAIRMAN. But you have a tax on personal property, such as furniture and other things, do you not?

Mr. PEIL. Not furniture; generally bank stock, and so forth.

The CHAIRMAN. When you levy that 4-mill tax, it exempts the bonds from personal property tax?

Mr. PEIL. Yes, sir; that is correct.

The CHAIRMAN. You are going back and getting away from that, and your municipal bonds will be subject to the personal property tax.

Mr. PEIL. We are going to repeal the act, so that the tax will not be applicable to municipal securities.

Now, the cities have been paying it only because we would have had to pay it anyhow, and, when we did try to pass it on to the bond holders, we had to pay two and one-half what we were attempting to save.

The CHAIRMAN. You stated a while ago that the 4-mill tax exempted the municipalities from the general property tax?

Mr. PEIL. It does in the hands of individuals.

The CHAIRMAN. Now, when you take it off, all of those bonds would be subject to the general property tax?

Mr. PEIL. No; they will be subject to no tax at all in the State of Pennsylvania.

The CHAIRMAN. That is not the way it would be in my State. Municipal bonds are considered personal property, and are subject to the general property tax, the same as real estate, but it generally escapes because it is difficult to find it. Is that your situation?

Mr. PEIL. No; our situation is slightly different. We have a property tax, the real estate tax for local government, schools, and counties, and then there is the personal property tax which goes to the county.

The CHAIRMAN. That personal property tax is made upon the corpus.

Mr. PEIL. The 4-mill tax is only upon the municipal and corporate indebtedness and other securities held by individuals. It is clearly a personal property tax. We do not co-mingle it with the real estate property tax.

In other words, when we in Easton levy our tax for the year, it is only as to real estate. The county has a 4-mill tax, which is the 1913 act. In 1935 there was an act passed by which the State got the money. We are abolishing that act this year, so far as it is applicable to municipal bonds. In other words, there will be no tax in Pennsylvania on municipal bonds when this act is repealed.

Senator BYRD. That is very unusual taxation, when you tax the municipality itself on bonds which it issues.

Mr. PEIL. I imagine it would be the same thing in Senator Brown's State. It is supposed to be paid by the bond holders, but, for the purpose of simplification, and so forth, we pay the tax, in view of the fact that the law makes it mandatory upon the issuing party to pay the tax.

Senator BYRD. But, is not the municipality exempted?

Mr. PEIL. Yes.

Senator BYRD. Take Virginia, for instance, we do not tax municipal bonds, and in other States they tax them in the hands of the holders. I did not know that there was any State that taxed the municipality.

Mr. PELL. Yes. That is the law that we are trying to get rid of. We find no sentiment in favor of it, and much sentiment against it.

The CHAIRMAN. Thank you, Mr. Peil.

We will now stand recessed until 2 o'clock tomorrow.

(Thereupon, at 4:35 p. m., the special committee recessed, to meet again at 2 p. m., Wednesday, February 8, 1939.)

TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

WEDNESDAY, FEBRUARY 8, 1939

UNITED STATES SENATE,
SPECIAL COMMITTEE ON TAXATION OF
GOVERNMENTAL SECURITIES AND SALARIES,
Washington, D. C.

The special committee met, pursuant to recess, at 2:30 p. m., in the committee room of the Senate Finance Committee, Senate Office Building, Senator Prentiss M. Brown, chairman, presiding.

Senator BYRD. The Chairman, Senator Brown is detained on official business, and has asked me to preside temporarily.

The committee will now hear from Mr. Walter R. Darby, representing Gov. A. Harry Moore, Governor of the State of New Jersey.

STATEMENT OF WALTER R. DARBY, COMMISSIONER OF LOCAL GOVERNMENT, REPRESENTING HON. A. HARRY MOORE, GOVERNOR OF THE STATE OF NEW JERSEY

Mr. DARBY. Gentlemen of the committee, His Excellency, A. Harry Moore, Governor of New Jersey, has asked me to represent him and the State at this hearing before your committee. Governor Moore was formerly a member of your honorable body and those of you who know him will appreciate the statement that there is no one in the State of New Jersey better able to meet the responsibility in this connection than Governor Moore himself. Please bear in mind that I am not taking the Governor's place; that, I cannot do. But the Governor's wish is my command and so I am here.

May I say that in exactly 2 months I will have served the State of New Jersey continuously for 22 years as the head of a State department having supervision and control over municipal budgets, finance and accounting and am therefore familiar with local government finance in the State of New Jersey. I have also had the privilege of serving as president of the association which is now the Municipal Finance Officers Association of the United States and Canada, also as president of the National Association of State Auditors, Comptrollers, and Treasurers.

Previous speakers have already presented or later speakers will present to your committee arguments on the various phases, legal and otherwise, of the question of Federal taxation of income of State and municipal bonds now before your committee more ably than I can, therefore, I do not propose to burden the record with the restatements of the general proposition. In the time allotted, I do want to point out the signular position of the State of New Jersey with respect to this matter.

In the first place New Jersey has no State income tax. It has never had such tax and there seems no present prospect that it will have one. Any reciprocal power to tax income of Federal bonds which may be granted to the States, is therefore without meaning in the case of New Jersey.

Senator MILLER. Is there any constitutional provision in New Jersey whereby you cannot levy an income tax?

Mr. DARBY. No; we can. It is not a question of power to levy an income tax, but it is a question of policy. If the proposed legislation were to become effective the result would be to further tax the residents of New Jersey and thereby reduce the wealth of the State as a whole. This would mean the reduction of the wealth on which taxes are now paid to the Federal Government for it is obvious that the amount paid out of income as taxes cannot be used for the purchase of services and commodities. The total income of the State would be cut and the amount of tax payable to the Federal Government would likewise be cut. This would be harmful to the State without a corresponding advantage to the Federal Government. The point here is that income from State and municipal bonds, although at present exempt from Federal tax as such, when it enters the channels of trade increases the income of business which is now subject to tax.

In the second place the State of New Jersey relies on taxes on real property for the support of local government to as great if not greater extent than any other State. In 1938 real estate bore more than 88 percent of all taxes levied locally for the support of government—State, county, and municipal. Out of a total tax of $256,000,000 levied in 1938, $226,000,000 was levied on real property. Almost all of this tax is for local purposes as only direct State tax levied on property for State use is some $900,000 for servicing soldiers' bonus bonds issued by the State.

Either as a result of general conditions or of the large tax on real estate, or both, the assessed valuations of real estate have progressively declined since 1930 as shown by the following:

The assessed valuations of real property for 1930 were $5,722,387,126 while for 1938 they were $4,991,527,491.

Senator BYRD. On what percent of the real value are the assessments made?

Mr. DARBY. The percent of real value as to assessed value?

Senator BYRD. Yes.

Mr. DARBY. It varies. The condition is that the assessors are slow to reduce values on properties. I would say that it varies anywhere from 30 to 150 percent in some cases.

Senator BYRD. Is this reduction due to the fact that the values of properties have gone down, or the assessment is reduced?

Mr. DARBY. This is recognizing the fact that real estate in New Jersey has gone down in value. Of course, as always happens when there is an upturn, when the market value of real estate is going up, the assessors are more likely to go up faster than when it turns the other way, and the market value of real estate comes down. The assessed values do not come down as fast as the actual values come down.

While the total tax levy has varied from $260,400,000 in 1931 to $228,800,000 in 1933 the amount of unliquidated tax liens has progressively mounted from $14,600,000 in 1930 to almost $105,000,000

at the close of 1939. It should be borne in mind that these latter figures are not assessed valuations of property but taxes and the amount of taxes in liens at the end of the year 1938 ($105,000,000) is approximately one-half of the real estate tax of 1938 ($226,000,000).

Senator BYRD. That has been accumulated over some years—the tax lien has been accumulating, as I say, over some years?

Mr. DARBY. Yes, sir. This is merely another way of stating that real estate conditions in New Jersey are, to put it mildly, not good. It has been said that in our State ownership of business property is a liability rather than an asset. As a further indication of the situation it is conservatively estimated that of the total valuation ($5,000,000,000) of real estate in New Jersey $1,000,000,000 or one-fifth is owned or controlled by insurance companies, savings banks, and building and loan associations. This means a large reduction in home owners in the State, which we regard as an undesirable trend from a social standpoint. The effect of a tax on the income of State and municipal bonds of New Jersey would be to increase the coupon rate of such bonds by three-fourths of 1 percent to 1 percent the latter probably being more nearly correct. The present bonded debt of the State and its subdivisions is around $1,000,000,000. One percent of this is $10,000,000—the added annual increase in interest which would be required. Of this sum $8,800,000 would fall on real estate—an increase of almost 4 percent based on 1938 figures. In many cases the net return at the present time on business property is not in excess of 1½ percent. To put an additional 4 percent on such properties would mean that they would be operating at a net loss of 2½ percent.

It is assumed that the tax would apply only to new issues of bonds but if New Jersey is to develop and we believe that it will in spite of present difficulties, new capital issues will be needed and in the course of time the figures used above would apply. Here again an argument similar to that used above applies. Levying additional taxes on real estate in New Jersey would further depreciate the values of real estate and aggravate a condition which is already very serious.

A Federal tax on the income of New Jersey State and municipal bonds would: (1) Be unjust to New Jersey because it has no State income tax and any reciprocal power of taxation would be of no effect so far as the municipalities are concerned. (2) Decrease the wealth of the State now subject to the Federal income tax; (*a*) by diverting from business channels the amount of tax; (*b*) by increasing the tax on real estate (already very heavy) and further depreciating real estate values. (3) Retard the development of a State from which the Federal Government is now receiving substantial payments of income taxes.

Based on the above the State of New Jersey respectfully objects to the proposal to tax the income of State and municipal bonds and wishes to be placed on record to that effect.

Senator BYRD. Thank you.

Senator MILLER. Do you have any especial taxes like the sales tax?

Mr. DARBY. We have no sales tax, and no income tax. The general revenues of New Jersey come in the main from motor vehicle licenses, inheritance tax, miscellaneous franchise tax on corporations, and some from banking and insurance.

Senator MILLER. And your real estate?

Mr. DARBY. Yes.

Senator LOGAN. Eighty-eight percent comes from real estate—that is 88 percent of that sum total of $256,000,000 comes from real estate?

Mr. DARBY. Out of $256,000,000 total tax levy, $226,000,000, or more than 88 percent, is from real estate.

Senator LOGAN. Then, in the next few years all of your real estate will go for the payment of taxes?

Mr. DARBY. We have been paying that for years, and got along all right as long as real estate had any value.

Senator LOGAN. I do not see how a State could run itself on 88 percent coming from real estate alone. That means that 4 cents out of every dollar goes for taxes. I do not see how any business property could return a profit on that basis.

Mr. DARBY. We did it until the depression.

Senator LOGAN. Thank you very much.

STATEMENT OF AUSTIN J. TOBIN, SECRETARY OF CONFERENCE ON STATE DEFENSE

Mr. TOBIN. If the committee please, I would like at this stage, following Mr. Darby's remarks, to read into the record a statement from Mr. S. S. Kenworthy, executive secretary of the New Jersey State League of Municipalities, addressed to this committee which reads:

GENTLEMEN: As executive secretary of the New Jersey State League of Municipalities I was expected to appear before your honorable body on Tuesday, February 7, in opposition to the suggestion that taxes be levied on the income from State and municipal securities.

It has come to our attention, however, that the Honorable Walter R. Darby, State commissioner of local government, is to appear on Wednesday, February 8, in behalf of Gov. A. Harry Moore. In view of this circumstance it appears unnecessary for this organization to be represented. The commissioner of local government is certain to express the viewpoints of the New Jersey State League of Municipalities and we heartily concur in his views on this important subject. The New Jersey State League of Municipalities consists of 350 communities and represents 95 percent of the total population of the State of New Jersey.

Also, I would like at this time to read into the record a letter addressed to me from Mr. Robert Moses, the chairman of the Triborough Bridge Authority, Randalls Island, N. Y.:

AUSTIN J. TOBIN, Esq.,
Washington, D. C.

DEAR MR. TOBIN: I am very sorry that because of press of city and State business here in New York, it is impossible for me to attend the hearings before the Special Committee on Intergovernmental Taxation. I am, however, giving to you the following information in the hope that it may be useful.

In recent years I have acted as the head of several so-called authorities in the city and State of New York, including the Henry Hudson Parkway Authority, Marine Parkway Authority, and New York City Parkway Authority, the Triborough Bridge Authority, and the Jones Beach State Parkway Authority, and Bethpage State Park Authority. In this capacity I have had charge of financing and refinancing toll bridges and other structures built and operated by these bodies. Most of the bonds have been sold in the open market.

On the 5th of April 1935, Henry Hudson Parkway Authority sold to the public $3,100,000 worth of bonds at 4 percent interest. These were due April 1, 1955, and sold at 99½. As of July 1, 1937, the said authority issued $2,000,000 more bonds at 3½ percent, due April 1, 1955, which were sold at par.

Marine Parkway Authority, on December 20, 1935, sold to the public $6,000,000 worth of bonds at 4½ percent due in 25 years, and sold at 99½.

Both of these authorities were consolidated with New York City Parkway Authority which, on March 29, 1938, issued $18,000,000 worth of bonds to retire

the bonds of the Marine and Henry Hudson Parkway Authorities and to obtain moneys for a new project, known as Cross Bay Boulevard Bridge, park and parkway improvements at Rockaway Beach. Thirteen million dollars worth of these were sold at par, bearing 3½ percent interest, and due April 1, 1968. Five million dollars worth of these were serial bonds bearing interest at 3½ percent, becoming due between 1940 and 1953, and yielding from 1.50 to 3.25.

Under my direction as chairman of the Triborough Bridge Authority, which had originally borrowed money for the Triborough Bridge from the Public Works Administration, refinanced this bond issue which had been taken over by the Reconstruction Finance Corporation, out of a new issue of $53,000,000 sold to the general public. This sale also provided sufficient moneys to build the new Bronx-Whitestone Bridge. Bonds aggregating $16,500,000 were dated April 1, 1937, and due April 1, 1977, bearing 4 percent interest. They were sold at 99¼. Eight million five hundred thousand dollars was in serial bonds, dated April 21, 1937, bearing 4 percent interest, becoming due between 1942 and 1968, and yielding from 2.65 to 3.90. Eighteen million five hundred thousand dollars in bonds were dated July 21, 1937, and become due in 1977, bore 4 percent interest and were sold at 104.50. Nine million five hundred thousand dollars was in serial bonds, dated July 21, 1937, bearing 4 percent interest, becoming due between 1942 and 1968, and yielding between 2.40 and 3.73.

All of these bonds are in the hands of private owners, trust companies, insurance companies, estates, etc.

It was necessary in each case to convince the investing public that these projects would be self-liquidating. In that connection it was vital that the interest rate be kept as low as possible. From my experience in negotiating the sale of these bonds I feel positive that if the investing public were not convinced that they were exempt from Federal and State income taxes, the bonds probably could not have been sold at all and funds would not have been obtained for these vital public improvements without resorting to taxation and large Government subsidies.

The same conclusion applies to bonds issued by other authorities for which I have been responsible.

Now, if the committee please, I wish to present various resolutions which have been adopted by organizations in the field of public administration, by municipal leagues, and by State and municipal agencies throughout the country.

For purposes of convenience we have grouped these resolutions into three categories: First, municipal league resolutions; second, resolutions of State, cities, and public agencies; and, third, resolutions adopted by organizations of public officials. The great majority, though not all, of these resolutions deal with the taxation of bonds and revenues and express unqualified opposition to such taxation by congressional statute. The majority also contend that the tax immune status of State and municipal bonds should be retained. The resolutions all oppose a retroactive imposition of Federal tax upon the salaries of State and municipal employees.

Rather than burden the committee by reading these resolutions into the record, I will simply list them and hand the resolutions to the clerk to be incorporated in the record of the proceedings. I must apologize for the seemingly haphazard appearance of these resolutions, but we thought it preferable to present the original copies as we received them from the secretaries of the various organizations, rather than offer copies to the committee.

The municipal leagues of the various States are, as the committee is aware, nonpolitical organizations representing the municipalities of their State. They serve as clearing houses of municipal information and advise on matters of municipal government and finance. They are strictly nonpartisan and include in their membership cities governed by all political parties.

The American Municipal Association is the parent association to which all municipal leagues belong. Represented in the American

Municipal Association are over 7,000 cities throughout the Nation. The American Municipal Association has gone on record in opposition to any proposed change in the present tax-exempt status of municipal bonds, unless the rights of the municipalities are actually protected by securing for them reciprocal taxing rights which, of course, could be done only through a constitutional amendment.

Typical of other resolutions adopted by the municipal leagues are the following:

From New York:

Whereas a tax on municipal bonds would be paid by real-estate taxpayers and not by investors in municipal securities * * *; Be it

Resolved, That the New York State Conference of Mayors and other municipal officials, with a membership of 189 cities, is opposed to the taxation of municipal securities and revenues by the Federal Government unless the legal consent of the State is obtained, the reciprocal taxation of Federal securities and revenues is guaranteed and municipalities are permitted to tax Federal property and the Federal Government is required to pay such taxes.

From Texas:

Resolved, That the League of Texas Municipalities is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtaining through a constitutional amendment permitting reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies.

From New Jersey:

Resolved, That the municipalities of New Jersey oppose the proposed plan of the Treasury Department to tax the interest on municipal bonds by simple act of Congress, and maintain that no such interference with the fiscal powers of the States should even be considered unless first submitted to the States in proper form of constitutional amendment.

From Arizona:

Resolved, That the Arizona Municipal League strongly recommends that the present tax-exempt status of municipal revenues and municipal obligations shall be maintained * * *.

From Oklahoma:

Resolved, That the Oklahoma Municipal League is vigorously opposed to any Federal tax upon State or municipal securities or the income of either * * *.

From Illinois:

Be it resolved, That the Illinois Municipal League go on record as being vigorously opposed to Federal taxation of municipal securities either in the past, present, or future.

In similar vein, we submit, therefore, resolutions of municipal leagues in the following States. The numbers that follow the State show the number of cities represented by that municipal league:

	Municipalities		Municipalities
Alabama	104	Nebraska	318
Arizona	84	New Jersey	340
Arkansas	133	North Carolina	151
California	241	North Dakota	127
Florida	63	New York	189
Idaho	46	Oklahoma	68
Illinois	703	Pennsylvania	44
Kansas	541	Texas	271
Kentucky	186	Utah	100
Maine	103	Virginia	129
Michigan	256	West Virginia	115
Minnesota	864		

Unfortunately the resolution from Mississippi is not available but we have been advised by the secretary of that league that such a resolution was adopted.

MUNICIPAL LEAGUES' RESOLUTIONS—CONFERENCE ON STATE DEFENSE

Resolutions on Federal Taxation of Municipal Revenues, Bonds, and Salaries

TEXAS [1]

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees, and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved, By the League of Texas Municipalities in convention assembled, at Port Arthur, Tex., on the 28th day of October 1938, that congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the League of Texas Municipalities is opposed to the taxation of State and municipal securities by the Federal Government unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the League of Texas Municipalities hereby approves and endorses the program and objectives of the Conference on State Defense to oppose the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee, and that the sense of this resolution be communicated by the respective members of the association to their congressional representatives as soon as may be.

Passed and approved this the 28th day of October, A. D. 1938, at Port Arthur, Tex.

Approved:

Wm. V. Brown,
President, League of Texas Municipalities.

Attest:
E. E. McAdams,
Executive Secretary.

NORTH DAKOTA

Whereas the President has recommended the abolition of the immunity of salaries of State and municipal employees and interest on State and municipal securities from the Federal income tax under the sixteenth amendment to the Constitution of the United States, and since under authority of the so-called *Port Authority case* and an opinion of the United States Department of Justice it appears that the United States Treasury Department intends to extend the application of that tax to these incomes: Now therefore, be it

Resolved, That the League of North Dakota Municipalities assembled in convention at Valley City, N. Dak., this 9th day of September 1938, takes the position on behalf of the cities of this State that the taxation of these incomes should

[1] Resolutions identical in form or effect were adopted and submitted by the municipal leagues of the following States: Arkansas, Kentucky, Maine, North Carolina, Pennsylvania, Virginia, and Alabama.

not be retroactive and that legislation should be adopted by Congress to provide that the taxation of any income in a classification previously held immune or exempt from taxes shall not be taxed for any years beyond the current year in which such exemption is abolished; that the Federal income tax should not be extended to apply to any income to municipalities from any source whatsoever; that if the power to tax incomes from State and municipal utilities, bonds and employees' salaries is granted to or exercised by the Federal Government, reciprocal rights shall be granted to the States, and that any loss of revenue experienced by the municipalities be offset by municipal sharing in State and/or Federally collected income taxes; be it further

Resolved, That the League of North Dakota Municipalities hereby approves and endorses the program and objectives of the Conference on State Defense to oppose the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities, or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of North Dakota, the Attorney General of the United States, the attorney general of the State of North Dakota, the chairman of the Senate Finance Committee, the chairman of the House Ways and Means Committee, to the Conference on State Defense and the American Municipal Association.

I hereby certify that the foregoing is a true and correct copy of the original resolution adopted by the annual convention of the League of North Dakota Municipalities held at Valley City on September 8, 9, and 10, 1938.

MYRON H. ATKINSON, *Executive Secretary.*

IDAHO

To the President and members of the Idaho Municipal Officers' Association, in convention assembled in Boise, Idaho, on December 7 and 8, 1938:

We, the undersigned special committee to which was referred the consideration of recent proposals of the Federal Government to tax the revenues of the States, counties, and municipalities, or their agencies, and the income on their bonds which are now outstanding, and also to tax future issues of bonds, and also to collect taxes on the salaries of officers and employees of States and municipalities earned from the year 1926 to the present time, do hereby respectfully report and recommend the adoption of the following resolution:

Whereas the Idaho Municipal Officers' Association has given due consideration to the threatened Federal proposal to tax the securities and bonds of the States and municipalities, and their agencies, which are now outstanding or which may hereafter be issued, and being convinced such legislation will cause: (1) Depreciation of the value of general obligation bonds to the unjust and inequitable loss of their owners and holders; (2) local improvement special obligation assessment bonds to become unsalable; (3) prevent or seriously retard the making of desirable and essential public improvements which have for their object the general welfare of municipalities; and (4) increase the cost of marketing and interest rate on such securities, which increased cost must be borne by the taxpayers, and the resultant increase in the cost of municipal government, and necessarily decrease efficiency in municipal government, and

Whereas we further believe that, as the officers and employees of the States and municipalities, and their agencies, have felt their salaries and income secure from taxation and that such exemption was strictly within the law, to now retroactively collect taxes on such income for past years from 1926 would be an unjustified burden: Now, therefore, be it

Resolved:

I. That the Idaho Municipal Officers' Association is opposed to the removal of the exemption on the securities and bonds of States and municipalities, and their agencies, whether now outstanding or hereafter to be by them, or either or any them, issued, except by their consent, and unless it be done by amendment to the Constitution of the United States, and providing that the States shall have the reciprocal power to tax Federal securities for revenue sufficient to provide revenue to offset such increased municipal costs.

II. That we are opposed to the collection of income taxes on the salaries of the officers and employees of States and municipalities, retroactively.

III. That we urge our representatives in the Congress of the United States to oppose all proposed legislation having for its object the removal of the exemptions on the securities hereinbefore mentioned except as hereinbefore provided, and to support all legislation proposed to prohibit the collection of the retroactive taxes hereinbefore mentioned.

IV. That a copy of this resolution was sent to: Hon. Wm. E. Borah, United States Senator; Hon. D. Worth Clark, United States Senator-elect; Hon. Compton I. White, Representative; Hon. Henry Dworshak, Representative-elect; Hon. J. W. Taylor, Attorney General; Conference on State Defense.

Respectfully submitted.

GEO. C. HUEBENER,
Chairman.
R. LEWIS ORD,
Mayor of Nampa.
HARRY L. HARPSTER,
Mayor of Burley.

UTAH

Whereas in the past practically all changes in taxation methods and the exemptions incident thereto have discriminated against municipalities by constantly reducing the local tax base in the face of continuing demands for essential governmental services; and

Whereas Federal taxation of municipal salaries, bonds, or agencies will deprive municipalities of the income levied against its inhabitants to defray the cost of municipal services. Now, therefore, be it

Resolved, That the Municipal League of Utah cognizant of this past experience strongly recommend that any proposed Federal tax be levied only with the consent of the State of Utah upon the municipalities, and that any taxation of municipal bonds and salaries should be reciprocal by actually securing for municipalities, through local taxation of State and Federal property and through a municipal share in State and Federally collected incomes, revenues sufficient to offset increased municipal costs.

Passed by the State Municipal League of Utah in its convention assembled at Ogden, Utah, September 17, 1938.

J. BRACKEN LEE,
President.
TOM MCCOY,
Secretary, State Municipal League of Utah.

MINNESOTA

Whereas securities and the income from securities issued by municipal governments are exempt from taxation by the Federal Government; and

Whereas there have recently been proposals that the Federal taxing power be extended to such securities and income; and

Whereas such proposals, if enacted into law, would add to the cost of State and local government by increasing the interest rate on such securities; and

Whereas, reciprocally, these arguments apply also to the exemption of Federal securities and the income thereof from State taxation;

Resolved, That the League of Minnesota Municipalities oppose any such attempt unless Federal taxation of the corporate revenues and already issued securities of the States, their subdivisions and agencies is prohibited and unless there is also secured to the States a guarantee of the reciprocal right to tax future issues of Federal securities and the income thereof.

ILLINOIS

Resolution passed by the executive committee of the Illinois Municipal League on October 6, 1938, at Springfield, Ill., in opposition to the Federal taxation on municipal salaries and securities, either in the past, present, or future

Whereas we have been advised that Federal authorities are seriously considering the taxation of municipal salaries and securities; and

Whereas the taxation of municipal salaries and securities by the Federal Government would impair the operating efficiency of municipal governments and increase the cost thereof to the taxpayers: Now, therefore, be it

Resolved by the executive committee of the Illinois Municipal League, That we hereby go on record as being vigorously opposed to Federal taxation of municipal salaries and securities, either in the past, present, or future.

AMERICAN MUNICIPAL ASSOCIATION

Whereas in the past practically all changes in taxation methods, and the exemptions incident thereto, have discriminated against municipalities by constantly reducing the local tax base in the face of continuing demands for essential governmental services; and

Whereas, Federal or State taxation of municipal salaries and bonds will raise municipal costs for these purposes; Now, therefore, be it

Resolved, That the American Municipal Association, cognizant of this past experience, strongly recommends that any proposed changes in the present tax-exempt status of municipal salaries and bonds should be reciprocal by actually securing for municipalities, through local taxation of State and Federal property, through a municipal share of State or federally collected income taxes, or otherwise, a revenue sufficient to offset such increased municipal costs.

THE WEST VIRGINIA LEAGUE OF MUNICIPALITIES,
December 23, 1938.

AUSTIN J. TOBIN,
Secretary, Conference on State Defense, New York City.

DEAR SIR: At a recent executive board meeting the following action was taken: Upon consideration of the recent Federal Treasury proposal that Congress attempt to (a) impose retroactive income taxes upon municipal employees, (b) tax outstanding municipal bonds, and (c) abolish the tax-free feature of all future municipal bond issues, the league executive board, by unanimous vote, joins other State leagues, Attorney General Clarence W. Meadows, and the national Conference on State Defense in opposing these measures, and resolves: That no method of accomplishing any of these purposes other than by constitutional amendment, and that West Virginia Congressmen be advised of this attitude.

Sincerely,

HUME K. NOWLAN,
Executive Secretary.

OKLAHOMA

Whereas the Federal Government, through an interpretation by the Department of Justice of the decision of the United States Supreme Court in *Helvering v. Gerhardt*, claims and assumes the power to tax outstanding State and municipal securities, revenues of State and municipal agencies, and salaries of all State and municipal employees; and

Whereas it is the opinion of the Oklahoma Municipal League in convention assembled that such a plan of procedure by the Federal Government is contrary to the fundamental and well accepted principles of our governmental system constitutes an unwarranted interference with State and municipal activities, would materially cripple or destroy local self-government, and should be resisted with every proper means: Therefore be it

Resolved, That the Oklahoma Municipal League is vigorously opposed to any Federal policy which may, or may appear, to tax State or municipal securities, or the income of either, or the salaries of employees thereof; and be it further

Resolved, That the Oklahoma Municipal League hereby approves and endorses the program and objectives of the Conference on State Defense consistent with the objectives herein enunciated; and be it further

Resolved, That the executive board of the Oklahoma Municipal League give this matter special attention and emphasis and map out a plan to accomplish the intent of this resolution; and be it further

Resolved, That each delegate to this convention report the adoption of this resolution to his governing body and adopt a resolution endorsing this resolution, and that each such resolution be sent to the city's Representative and Senator in Congress; and be it further

Resolved, That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee, and to the chairman of the House Ways and Means Committee.

Adopted, the Oklahoma Municipal League, in convention assembled, this 22d day of November 1938.

J. W. FLINT, *President.*
FRANK C. HIGGINBOTHAM,
Executive Secretary.

MICHIGAN, NUMBER 2

Resolution on taxing the income of municipal employees

Whereas under the recent decision of the United States Supreme Court in *Helvering* v. *Gerhardt* the Federal Government may have the supreme power to tax all State and municipal employees, and whereas such decision may have the retroactive effect of taxing such employees upon all compensation earned since 1926, and

Whereas retroactive taxation has always been regarded as contrary to American principles of government: Now, therefore, be it

Resolved, By the Michigan Municipal League in convention assembled at Detroit, Mich., on the 17th day of November 1938, that congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future, and be it further

Resolved, That a copy of this resolution be sent to the governing body and chief administrative official of each city and village in the State with a request that this resolution be read at the next regular meeting of such governing body and that it, in turn, adopt a similar resolution for transmission to its Congressmen and Senators, and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Michigan, to the Attorney General of the United States, the Governor, Governor-elect, after he assumes office, Attorney General, and Attorney General-elect, of the State of Michigan, to the Chairman of the Senate Finance Committee and to the Chairman of the House Ways and Means Committee.

MICHIGAN, NUMBER 3

Resolution on Federal taxation of municipal revenues and bonds

Whereas the Federal Government now claims to have the supreme power under the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* to tax the income from future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved, That the Michigan Municipal League deems it inadvisable to place in the hands of the Federal Government the power to weaken and destroy the local governmental units of the Nation by taxing their securities and revenues and is, therefore, opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting any Federal taxation of State and municipal revenues other than bonds, and be it further

Resolved, That a copy of this resolution be sent to the governing body and chief administrative official of each city and village in the State with a request that this resolution be read at the next regular meeting of such governing body and that it, in turn, adopt a similar resolution for transmission to its Congressmen and Senators, and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Michigan, to the Attorney General of the United States, the Governor, Governor-elect, after he assumes office, Attorney General, and Attorney General-elect, of the State of Michigan, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee.

FLORIDA

Whereas the Federal Government contends, under the decision by the United States Supreme Court in *Helvering* v. *Gerhardt*, "that the principle of immunity protected the Federal Government against taxation by the States but did not

necessarily shield the States against the exercise of the delegated, and supreme taxing power of the Central Government;" and

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal and county bonds, as well as future municipal and county bond issues; and

Whereas the Federal Government also claims the power to impose the Federal corporate-income tax on the revenues of State, county, and municipal agencies, such as power, light and gas, toll bridges, water supply, and other revenue-producing functions; and

Whereas the Federal Government further claims the power to tax the salaries of municipal, county, and State employees, and such employees are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926: Now, therefore, be it

Resolved by the Florida League of Municipalities in convention assembled, at Pensacola, Fla., this 2d day of December A. D. 1938, That if municipal, county, and State securities are to be taxed by the Federal Government, the consent of the States should first be obtained through a constitutional amendment, permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal taxation of any of the revenues of the States, counties, and municipalities, and their respective agencies; and be it further

Resolved That congressional legislation should be passed at the next session of Congress to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities, counties, and States, and their respective subdivisions and instrumentalities; and be it further

Resolved, That the financial loss to local units of government and their agencies through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local taxation of Federal property, or service charges in lieu thereof, or for a municipal share of federally collected income taxes, or otherwise; and be it further

Resolved, That a copy of this resolution be sent to each Senator and Representative of Florida in Congress, and to the council on State defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

A true copy.

Attest:

[SEAL]

E. P. OWEN, Jr.,
Secretary, Florida League of Municipalities.

ARIZONA

Resolution of State defense

Be it resolved, That the Arizona Municipal League cooperate with the United States Conference on State Defense against the encroachment of the Federal Government and States' rights as contained in the first 10 amendments to the Constitution of the United States, and that a copy of this resolution be sent to Mr. Austin J. Tobin, secretary of the United States Conference on State Defense.

Resolution on the taxation of municipal revenues, salaries, and bonds

Whereas under our constitution the guarantee that the States should remain forever free is the first premise of American Government; and

Whereas the principle or immunity that protects the Federal Government against taxation by the States, this same principle should also protect the States and their political subdivisions and political units from being taxed by the Federal Government; and

Whereas Federal or State taxation of municipal revenues will set a very dangerous precedent: Now, therefore, be it

Resolved, That the Arizona Municipal League at its 1938 fall meeting in Phoenix, Ariz., strongly recommends that the present tax-exempt statutes of municipal revenues and municipal obligations shall be maintained and further requests that our Senators and Congressmen strongly oppose any legislative measure that attempts to change this basic principle.

CALIFORNIA

Resolution of the League of California Municipalities opposing Federal policy on income taxation

Whereas certain departments of the Federal Government are asserting the supreme power in the Federal Government to tax States without their consent and at the same time denying any reciprocal right of the States to tax bonds, agencies, and employees of the Federal Government; and

Whereas the Department of Justice has set forth in a report to the Treasury Department that the Federal Government has the power to levy an income tax on the revenues of the States, and agencies of the States and municipalities, and also in said report it is claimed that bonds of the States and State agencies heretofore issued or to be issued, and salaries of the employees of the States and municipalities, are subject to Federal income-tax levies; and

Whereas it is the sense of the League of California Municipalities that any attempt on the part of the Federal Government to accomplish these purposes by an act of Congress is an attack on the sovereignty of the States and in violation of both the spirit and the letter of the Federal Constitution: Now, therefore, be it

1. The league contends that the revenues of public enterprises carried on by the State and local governments, whether they be essential governmental functions or not, must continue to be exempt from Federal tax just as we believe the revenues of the Federal Government should be exempt from taxation by the State and local governments.

2. The league recommends the passage of Federal legislation to prohibit the application to public employees of any retroactive assessments and penalities in connection with the payment of Federal income tax, in the event public employees should later be required to pay Federal income tax.

3. The league opposes any attempt to extend the Federal income tax to the salaries of State and local employees or to the interest paid on State and local bonds unless and until the consent of the States shall first have been obtained through an amendment to the Federal Constitution.

4. Any proposed amendment to the Constitution to make the interest on State and local bonds subject to the Federal income tax should provide for State and local taxation of Federal bonds on the same legal basis, but in both cases the application of these taxes to outstanding bond obligations should be prohibited.

5. Any proposed amendment to the Constitution to extend the Federal income tax to State and local employees should provide the same legal basis for the extension of State income taxes to Federal employees.

6. The president of the league is requested to appoint a committee to confer with State, county, and district offices to map out a plan to accomplish the objectives outlined above.

Resolution of Los Angeles County League of Municipalities

Whereas concerted efforts are now being made to subject to Federal taxation the income from municipal bonds and the salaries of municipal employees, and to give such taxation retroactive effect; and

Whereas the taxation of income from municipal bonds would inevitably result in increasing the cost of local government, and, insofar as retroactive, would work a serious injustice to persons who paid a higher prices for such bonds, relying upon their exemption from taxation than they otherwise would have paid; and

Whereas the retroactive taxation of the income of municipal employees would be financially ruinous and unfair to those employees and injurious to the communities in which they reside: Now, therefore, be it

Resolved, That the Los Angeles County League of Municipalities and its members:

(1) Condemn as unfair, oppressive and un-American the imposition of retroactive taxes upon the income from municipal bonds and municipal salaries;

(2) Condemn the unwarranted extension of Federal power and the weakening of local government through the taxation of income from municipal bonds to be issued in the future;

(3) Urge that if equitable and nonretroactive taxation of the income from municipal salaries hereafter be contemplated, such taxation be authorized only on the condition that the State be afforded the reciprocal right to tax income from Federal salaries;

(4) Are convinced that the radical change in relationship between local and Federal Government that is inherent in current efforts to tax municipal securities and salaries should be accompanied only by sanction of the people as a whole, expressed through well considered amendment of the Constitution, and not by judicial lawmaking, and be it further

Resolved, That we hereby urge all candidates for election to the Congress to carefully consider the views herein expressed, and to lend their constant support to all proper legislative means for carrying them into effect.

KANSAS

That the League of Kansas Municipalities herewith requests our Senators and our Representatives in the National Congress to pursue such action as will preserve to the people of our respective communities the right to govern themselves within those communities, and that they should vote against each, every, and all measures that are calculated to or may have the effect of destroying the local government of the communities, placing a burden upon local governments, and of reducing the efficiency of the local governments or of injuring their credit or increasing their debt burden or the charges therefor.

NEW JERSEY

Whereas the Federal Department of Justice has recently asserted that the Central Government has a supreme power to tax the States; and

Whereas upon the basis of such an assertion the Treasury Department now proposes, by act of Congress, to tax the income from municipal bonds, a step which would inevitably lead to the taxation of outstanding municipal securities, and might open the door to Federal taxation of municipal revenues; and

Whereas such a proposal, unless first submitted to the States in the form of a constitutional amendment, would be subversive of the sovereignty and independence of the States, and an unconstitutional interference with their fiscal powers; and

Whereas such a tax would, in any event, greatly increase the cost of municipal financing, and so add to the burdens of local real-estate taxation; and

Whereas as a result of recent decisions of the Supreme Court, many municipal employees may be liable for Federal income taxes on their past salaries from 1920 to date: Now, therefore, be it

Resolved by the New Jersey State League of Municipalities in Convention Assembled:

First. That the municipalities of New Jersey oppose the proposed plan of the Treasury Department to tax the interest on municipal bonds by simple act of Congress, and maintain that no such interference with the fiscal powers of the States should even be considered unless first submitted to the States in proper form of constitutional amendment.

Second. That our league supports the enactment of remedial legislation to set aside any liability of our municipal employees for back taxes on salaries received by them from 1920 to date.

Third. That our league cooperate in the program and objectives of the Conference on State Defense, to the end that the integrity and sovereignty of the States in this Nation may be preserved; and

Fourth. That the executive secretary is hereby directed to forward copies of this resolution to the Senators and Congressmen from New Jersey, with the request of the league that they oppose this attempt to raise Federal revenue at the direct expense of local government, and with resulting increases in local taxation, and with the further request that they stand firm on this issue for the principle of State independence and sovereignty.

NEW YORK

Whereas the Federal Government is considering the enactment of a law providing for the taxation of the incomes from all future municipal bond issues and all municipal utilities; and

Whereas there is grave doubt as to whether the Federal Government can tax such incomes without a constitutional amendment; and

Whereas it is estimated that the taxation of municipal bonds would increase from one-half of 1 percent to 2 percent the interest rate the municipalities would have to pay; and

Whereas this tax would be paid by the real-estate taxpayers, and not the investors in municipal securities; and

Whereas justice dictates that if the Federal Government taxes municipal bonds and revenues and loads an additional financial burden on city and village taxpayers, the States should in turn be given the right to impose taxes on Federal securities and the cities and villages to levy a tax on Federal property within their boundaries; and

Whereas Federal taxation of municipal bonds and revenues would increase the present tax discrimination against cities and villages and their taxpayers: Be it

Resolved That the New York State Conference of Mayors and other municipal officials, with a membership of 180 cities and villages, is opposed to the taxation of municipal securities and revenues by the Federal Government unless the legal consent of the State is obtained, the reciprocal taxation of Federal securities and revenues is guaranteed, and municipalities are permitted to tax Federal property and the Federal Government is required to pay such taxes; and be it further

Resolved, That we petition the New York State Representatives in the United States Senate and House of Representatives to oppose any legislation taxing municipal securities and revenues unless the reciprocal provisions are included.

LEAGUE OF NEBRASKA MUNICIPALITIES,
LINCOLN, NEBR., *October 17, 1938.*

Mr. AUSTIN J. TOBIN,
Secretary, Conference on State Defense,
New York City, N. Y.

DEAR MR. TOBIN: Our league also went on record as passing a resolution as follows:

Whereas the Department of Justice now interprets the duties of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has a supreme power to tax all State and municipal employees; and

Whereas all State and municipal employees now face the imminent danger of basing income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenue of State and municipal agencies: Now, therefore, be it

Resolved by the league, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it

Further, being distinctly understood that the league does not oppose Federal income taxation on future salaries of municipal officials.

Resolved, That the League of Nebraska Municipalities are opposed to the taxation of State and municipal securities by the Federal Government, and unless the consent of the State is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal security, their prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenue of the State and municipal agencies; and be it

Further resolved, That the League of Nebraska Municipalities hereby approves and endorses the program and objectives of the conference on State defense to oppose the program and objectives of the Federal Government to tax and unless by constitutional amendment to obtain legislation providing the retroaction of taxation of the salaries of State and municipal employees and to obtain prohibition against the Federal Government taxing the revenues of States and municipalities or their agencies; and, be it

Further resolved, That certified copy of this resolution be sent to the Senators and Congressmen representing the State of Nebraska, to the Attorney General of the United States, to the attorney general of the State of Nebraska, to the chairman of the Finance Committee, and to the chairman of the Ways and Means Committee.

Yours very truly,

C. E. BEALS,
Executive Secretary.

In the second category of State, city, and public agencies we have many resolutions. Typical of these is the resolution adopted by the National Association of Attorneys General, representing all the attorneys general of the 48 States, which reads in part:

Whereas the Department of Justice * * * asserts a supreme power in the Central Government to tax the States without their consent * * * and

Whereas it is the sense of this association that such a Federal attack would place the States in the status of counties or provinces of a Central Government, and would in effect destroy the form of State and local government, and of dual sovereignty, under which the people of the United States have lived and prospered for over a century and a half; * * *

Now, therefore, be it

Resolved, That the National Association of Attorneys General denies the constitutionality of any attempt by the Federal Government to tax the revenues of the States, or the exercise of their fiscal powers, without the consent of the States first obtained through proper constitutional process; * * *

Similar resolutions were adopted by: The Municipal Finance Officers Association of America representing 675 comptrollers and other municipal finance officers; the American Association of Port Authorities; the American Water Works Association, representing 2,650 individual members and 250 corporate members, a large majority of whom are engaged in municipal water supply; the State Industrial Commission of Utah; Investment Bankers Association of America; Municipal Finance Officers' Association, Texas Chapter; New York State Association of Municipal Engineers; County Officers Association of Oklahoma; Board of County Commissioners of Ramsey County, Minn.; Joliet Park District; Association of County Assessors of the State of California; Board of Supervisors of the County of Los Angeles, Calif.; Board of Supervisors of Los Angeles County Flood Control District, Calif.; Municipal Lighting Association of Massachusetts; Maine Water Utilities Association; the State Port Authority of Virginia; city of Marshall, Tex.; city of Coral Gables, Fla.; city of Sharon, Pa.; city of Jacksonville, Fla.; city of Chester, Pa.; city of Newcastle, Pa.; city of Akron, Ohio; city of Orlando, Fla.; city of Newport News, Va.; city of Portland, Oreg.; city of Pasadena, Calif.; city of Des Moines, Iowa; city of Norwalk, Conn.; city of Lakeland, Fla.; city of Macomb, Ill.; city of Fargo, N. Dak.; city of Detroit, Mich.; city of Newport, R. I.; city of Duluth, Minn.; city of St. Paul, Minn.

RESOLUTIONS OF STATE, CITY, AND PUBLIC AGENCIES—CONFERENCE ON STATE DEFENSE

Resolution of the Municipal Forum of New York

Whereas the President has proposed to Congress the enactment of Federal legislation to tax the income from State and municipal bonds issued subsequent to the passage of such legislation, without giving the States the opportunity of determining for themselves whether or not they are willing for the Federal Government to tax such income; Now, therefore, be it

Resolved, by the Municipal Forum of New York, That said Municipal Forum of New York opposes the proposal of the President to authorize the Federal Government to levy taxes upon the income to be derived from State and municipal securities thereafter issued by congressional act; and be it further

Resolved, That the Municipal Forum of New York is of the opinion that no proposal for the taxation of the income from State and municipal securities by the Federal Government should be put into effect until and unless the States shall have had an opportunity to consent to such taxation by the submission to the States of a constitutional amendment authorizing such taxation, which amendment should provide for reciprocal taxation of Federal securities by the

States and their agencies, and proper safeguards upon the exercise of such power of taxation by either the Federal Government or by the States and their agencies; and be it further

Resolved, That the Secretary be, and he hereby is, authorized to deliver a copy of this resolution to the congressional committee presently studying the aforesaid proposal of the President.

FEBRUARY 2, 1939.

MOBILE

Whereas an effort is being made to induce the Congress of the United States to pass legislation taxing the income derived from securities issued by sovereign States and their political subdivisions (H. R. 1701, S. 554); and

Whereas outstanding economists have estimated that the levying of a Federal tax on the income from municipal bonds will result in municipalities having to pay an increased rate of interest on such bonds equal to approximately twice as much as the Federal tax, thereby causing the local taxing powers to lose approximately $2 every time the Federal taxing power gains $1 in consequence of such proposed legislation; and

Whereas cities generally do not have the power to impose a municipal income tax on securities issued by the United States Government, even should Congress grant such power, due to prohibitive State laws; and

Whereas it is believed, as stated in many United States Supreme Court decisions, that the power to tax is the power to destroy, and that the giving of such power to the Federal Government would be a step toward the establishment of a totalitarian state and would enable the Central Government to use coercion in forcing through its policies by the weapon of driving State and municipal securities from the market through heavy taxation: Now, therefore, be it

Resolved by the Board of Commissioners of the city of Mobile as follows:

SECTION 1. Each Senator and member of the House of Representatives of the United States Congress is hereby requested to use every effort to prevent the passage of the proposed legislation.

SEC. 2. The city clerk is hereby directed to send a certified copy of this resolution to each such Senator and Representative and to the following-named additional persons:

Hon. Austin J. Tobin, secretary, Conference on State Defense, 111 Eighth Avenue, New York, N. Y.

Hon. John A. McIntire, executive director, National Institute of Municipal Law Officers, 730 Jackson Place NW., Washington, D. C.

Hon. Frank M. Dixon, Governor of Alabama, Montgomery, Ala.

Hon. Hugh D. Merrill, speaker of the House of Representatives, Montgomery, Ala.

Hon. Paul V. Betters, executive director, United States Conference of Mayors, 730 Jackson Place NW., Washington, D. C.

Hon. Ed Reid, executive secretary, Alabama League of Municipalities, Exchange Hotel, Montgomery, Ala.

Hon. A. A. Carmichael, lieutenant governor, State of Alabama, Montgomery, Ala.

Adopted.

S. H. HENDRIX, *City Clerk*.

JANUARY 31, 1939.

DULUTH

(By Commissioner Williams)

Resolved, That the city council of the city of Duluth hereby respectfully petitions the Congress of the United States of America to oppose and to defeat any Federal legislation designed or intended to place a tax on municipal salaries and bond interest; and be it further

Resolved, That if such petition be denied, and the Congress of the United States does enact a law imposing a tax on municipal salaries and bond interest, that in such case the Congress shall at the same time confer authority and power upon each of the several States of the United States to impose a State tax on Federal salaries and bond interest, and upon real estate owned by the United States of America and situated in the several States; and be it further

Resolved, That the city clerk of the city of Duluth is hereby authorized and directed to mail a certified copy of this resolution to each Senator and Representative representing the State of Minnesota in the Senate and House of Representatives of the United States, to the Conference of State Defense, 111 Eighth Avenue, New York, N. Y., and to C. C. Ludwig, executive secretary of the League of Minnesota Municipalities, Minneapolis, Minn.

Commissioner Williams moved the adoption of the resolution and it was declared adopted upon the following vote:

Yeas: Commissioners Bodin, Culbertson, Merritt, Williams; Mayor Berghult, total, 5.

Nays: None.

Approved:

C. A. WILLIAMS,
Commissioner of Finance.

Adopted, December 19, 1938.
Approved, December 19, 1938.

OFFICE OF CITY CLERK,
Duluth, Minn.

I, C. D. Jeronimus, city clerk of the city of Duluth, in the State of Minnesota, do hereby certify that I have compared the annexed copy of resolution passed by the city council of the city of Duluth, on the 19th day of December 1938, with the original document and record thereof on file and of record in my office, and in my custody as city clerk of said city, and that the same is a true and correct copy thereof, and the whole thereof, and a true and correct transcript therefrom.

In witness whereof, I have hereunto set my hand and affixed the corporate seal of said city of Duluth, this 20th day of December 1938.

CITY OF DULUTH, MINN.
C. D. JERONIMUS, *City Clerk.*
By T. HOLMBERG, *Deputy.*

ST. PAUL

OFFICE OF THE CITY CLERK

COUNCIL RESOLUTION—GENERAL FORM

(Presented by Mayor W. H. Fallon)

Whereas there is now pending before the Congress of the United States a proposal wherein it is sought to have legislation adopted by means of which income taxes will be levied upon the income derived from interest on municipal bonds and also from the levy of a Federal income tax upon salaries of State and municipal employees; and

Whereas the municipalities and especially the larger municipalities of this country are now admittedly staggering under the excess burden of taxation caused by the large number of persons on relief rolls, and such municipalities are finding it increasingly difficult to obtain the money necessary for the relief of such poor persons; and

Whereas the levy of a Federal income tax upon income derived from interest on municipal bonds would necessarily increase the carrying charges of such bonds and would increase the interest rate to be paid by such municipalities; and

Whereas the salaries of the employees of the city of St. Paul are in the main based upon a cost-of-living wage ordinance wherein salaries are increased or decreased depending upon the current cost of living, and the levy of a Federal income tax on such salaries would undoubtedly bring about a concerted effort on the part of such employees to have their salaries increased to compensate for such Federal taxes and thereby further increase the cost of such municipal government; and

Whereas the proposal to afford the right of the various States to levy a State income tax upon the salaries of Federal employees located within the boundaries of each State would in no way assist the financial condition of the city of St. Paul for the reason that the State income tax already adopted by the Legislature of the State of Minnesota has caused a heavy burden upon the taxpayers of such city, with no appreciable decrease in the other taxes payable for the carrying on of such municipal government, and the income-tax law of the State of Minnesota is

such that the city of St. Paul will not benefit by any increase in the income attributable to that fund; and

Whereas in the opinion of the city council of the city of St. Paul the adoption of such legislation levying such Federal income tax would be improper, unwise, and unfair and would cause an additional burden on the finances of said city: Therefore be it

Resolved, By the City Council of the City of St. Paul that it opposes the adoption of such legislation and urges the Senators and Representatives in Congress from the State of Minnesota to oppose the adoption of such legislation; be it further

Resolved, That copies of this resolution be forwarded to the President of the United States, each Senator and Representative from Minnesota in Congress of the United States, to the Conference on State Defense, at 111 Eighth Avenue, New York City, and to the Conference of Mayors, in Washington, D. C.

Adopted by the council, January 19, 1939.

Approved, January 19, 1939.

W. H. FALLON, *Mayor*.

NEWPORT

Resolved, That the Representative Council of the city of Newport, R. I., go on record as disapproving any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds or the salaries of State and local governmental employees, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to the United States Senators and Representatives in Congress from the State of Rhode Island, urging them to use their efforts against the proposed legislation.

In representative council, December 6, 1938; read and passed.

A true copy. Attest:

[SEAL] D. NORMAN SAYER,
City Clerk.

NEW CASTLE, PA.

Resolved, by the Council of the city of New Castle, Pa., That we go on record as endorsing the action taken at the Convention of the League of Cities of the Third Class in Pennsylvania, held on September 1 and 2, 1938, in the city of Reading, condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our Representative in Congress, urging them to do all in their power to carry out our wishes.

FLORIDA LEAGUE OF MUNICIPALITIES AS READOPTED BY ORLANDO, FLA.

Whereas the Federal Government contends, under the decision by the United States Supreme Court in *Helvering* v. *Gerhardt*, "That the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated, and supreme, taxing power of the Central Government." And

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal and county bonds, as well as future municipal and county bond issues, and

Whereas the Federal Government also claims the power to impose the Federal corporate income tax on the revenues of State, county, and municipal agencies, such as power, lights, and gas, toll bridges, water supply, and other revenue-producing functions, and

Whereas the Federal Government further claims the power to tax the salaries of municipal, county, and State employees, and such employees are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926. Now, therefore, be it

Resolved by the Florida League of Municipalities, in convention assembled, at Pensacola, Fla., this 2d day of December, A. D., 1938, That if municipal, county, and State securities are to be taxed by the Federal Government, the consent of the States should first be obtained through a constitutional amendment, permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal taxation of any of the revenues of the States, counties, and municipalities, and their respective agencies; and be it further

Resolved, That congressional legislation should be passed at the next session of Congress to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities, counties, and States, and their respective subdivisions and instrumentalities; and be it further

Resolved, That the financial loss to local units of Government and their agencies through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local taxation of Federal property, or service charges in lieu thereof, or for a municipal share of federally collected income taxes, or otherwise; and be it further

Resolved, That a copy of this resolution be sent to each Senator and Representative of Florida in Congress, and to the Council on State Defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

E. P. OWEN, *Mayor.*
FRANK W. REID,
G. WAYNE GRAY,
W. KENNETH MILLER,
COLIN MURCHISON,
Commissioners.

PORTLAND, OREG.

RESOLUTION NO. 21556

Now, therefore, be it resolved, that the Council of the city of Portland deems it inadvisable that the Congress place in the hands of any Federal department the power to weaken and destroy the local governmental units of the Nation by taxing their securities and revenues and is, therefore, opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting any Federal taxation of State and municipal revenues other than bonds, and

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Oregon, to the Attorney General of the United States, the Governor and the attorney general of the State of Oregon, and to the chairmen of the senate and house ways and means committee of the Oregon State Legislature.

Adopted by the council, January 19, 1939.

WILL E. GIBSON,
Auditor of the city of Portland.

CERTIFICATION OF COPY

STATE OF OREGON,
County of Multnomah,
City of Portland, ss:

I, Will E. Gibson, auditor of the city of Portland, do hereby certify that I have compared the foregoing copy of Resolution No. 21556 with the original thereof, and that the same is a full, true, and correct transcript of such original Resolution No. 21556 and of the whole thereof as the same appears on file and of record in my office, and in my care and custody.

In witness whereof, I have hereunto set my hand and the seal of the city of Portland affixed this 21st day of January 1939.

[SEAL]

WILL E. GIBSON,
Auditor of the city of Portland.
By R. S. IVEY, *Deputy.*

JACKSONVILLE, FLA.

Whereas, this board is informed that the Federal Government contends, under a decision by the United States Supreme Court in *Helvering* v. *Gerhardt* "that the principle of immunity protected the Federal Government against taxation by

the States but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the Central Government," that it has the power to tax outstanding as well as future issues of municipal and county bonds; to impose the Federal corporate income tax on the revenues of State, county and municipal agencies such as power, lights, and gas, water supply, and other revenue-producing functions; and to tax the salaries of municipal, county, and State employees, even so far as to make same retroactive over a period of more than 10 years: Now, therefore, be it

Resolved by the City Commission of the city of Jacksonville, Fla., in special session this 23d day of January A. D. 1939, That if municipal, county, and State securities are to be taxed by the Federal Government the consent of the States should first be obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal taxation of any of the revenues of the States, counties, and municipalities, and their respective agencies; be it further

Resolved, that congressional legislation should be passed at the present session of the Congress to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities, counties, and States, and their respective subdivisions and instrumentalities, and be it further

Resolved, That the financial loss to local units of government and their agencies through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local taxation of Federal property, or service charges in lieu thereof, or for a municipal share of federally collected income taxes, or otherwise, and be it further

Resolved, That a copy of this resolution be sent to each Senator and Representative of Florida in Congress, and to the Council on State Defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

A true copy.

Attest:

[SEAL]

M. W. BISHOP,
Secretary City Commission.

CORAL GABLES

RESOLUTION NO. 1875

CORAL GABLES

RESOLUTION NO. 1111

Whereas the Federal Government contends under the decision by the United States Supreme Court in the case of *Helvering* v. *Gerhardt*, that the principle of immunity from taxation protects the Federal Government against taxation by the several States but does not necessarily shield the States and their governmental units against the exercise of the delegated and supreme taxing power of the Federal Government; and

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal bonds and securities, as well as future issues; and

Whereas the Federal Government also claims the power to impose the Federal corporate income tax on the revenues of municipal proprietary revenue-producing functions and operations; and

Whereas the Federal Government further claims the power to tax the salaries of municipal employees, and that such authority may include the back-assessment of such taxes for each year back to 1920; now, therefore, be it

Resolved by the Commission of the City of Coral Gables, Fla.: 1. That if municipal, State, and county securities are to be taxed by the Federal Government, the consent of the several States should be obtained first through a constitutional amendment permitting the reciprocal taxation of Federal securities by the several States.

2. That congressional legislation should be enacted specifically relieving from Federal taxation any and all revenues of municipalities and their agencies.

3. That congressional legislation should be enacted to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities.

4. That the financial loss to the States and their local units of government through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local

taxation of Federal property, or service charges in lieu thereof, or for the municipalities to share in the federally collected income taxes, or otherwise.

5. That a copy of this resolution be sent to each Senator and Representative of Florida.

I, G. N. Shaw, clerk of the city of Coral Gables, Fla., do hereby certify that the above and foregoing is a true and correct copy of Resolution No. 1375, passed and adopted by the commission of said city on December 13, 1938.

Witnesseth my hand and the official seal of the city of Coral Gables, Fla., this 20th day of January A. D. 1939.

[SEAL] G. N. SHAW, *City Clerk.*

AMERICAN WATER WORKS ASSOCIATION

RETROACTIVE TAXATION OPPOSED

Following the general line of action taken by several of the sections in reference to the Federal Government imposing a retroactive tax on public employees' salaries and taxing other State activities, the board of directors adopted the following resolution in reference to retroactive taxation of salaries of State and municipal employees:

"Whereas recent judicial decisions relative to the liability of employees of the States and their civil subdivisions for Federal taxation of their income have been interpreted to authorize the Internal Revenue Department to enforce a collection of such taxes not alone for the 1938 period, but also retroactively for the entire period of years for which there may be legal liability under existing laws as now interpreted.

"Whereas many of the members of the American Water Works Association, who are employees of States or their political subdivisions, have been led by the tenor of previous judicial decisions to consider themselves not liable for Federal income tax, and in good faith have so acted; and

"Whereas it has been reported that, in a very recent press conference, the President of the United States has indicated that he would recommend that legislation be enacted to remove the possibility of retroactive taxation of such persons: Therefore, be it

"*Resolved by the Board of Directors of the American Water Works Association, in annual meeting assembled in New York, on January 18, 1939,* That it approve and heartily support the recommendation that the Congress enact such legislation as will relieve State and municipal employees from the possibility of retroactive Federal income taxation."

At the time this action was taken the President had not sent his message of January 19 to Congress, in which he recommended the enactment of legislation that would eliminate the retroactive feature of the application of the Federal income tax to salaries of employees of States and their subdivisions.

The board of directors also adopted a resolution in reference to the taxation of interest on bonds of States and their subdivisions as follows:

"Whereas the Federal Department of Justice has advised the Treasury Department, 'that the principle of immunity protected the Federal Government against taxation by the States, but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the Central Government'; and

"Whereas the enforcement of this opinion would affect the States and their political subdivisions by taxation of the interest paid on their bonds and other certificates of indebtedness; and

"Whereas the financial situation of the water supply systems that are under the control of municipalities, or other political subdivisions of the State, would be vitally affected by the Federal Government taxing the interest upon the securities of such systems; and

"Whereas it would manifestly be unfair to the present owners of municipal water bonds to be taxed on the income derived from such bonds, when the bonds were sold on the basis that such income was legally tax exempt: Therefore, be it

"*Resolved by the board of directors of the American Water Works Association at the annual meeting, assembled in New York on January 18, 1939,* That it oppose any Federal taxation of already issued water supply or other securities of the States, their subdivisions and agencies; and that the right of the Federal Government to tax future issues of securities of the States, their subdivisions and agencies, should only be granted if the consent of the States is first secured through the adoption of a constitutional amendment that would guarantee the reciprocal

right of each State to tax future issues of Federal securities, as they may be held within the various States."

W. W. Brush advised the directors that the Congressional Committee on Taxation would hear those interested in this subject starting February 7, and it was understood the association would be represented at these hearings.

Maine Water Utilities Association

Whereas a large majority of the attorneys general, among them Hon. Frank W. Burkett, of Maine, recognizing a menace from the Federal Government to impair the sovereignty of the several States and their freedom from any outside interference, which has been one of the greatest bulwarks of American democracy for the past century and a half.

Whereas said conference on State defense has actively undertaken to secure cooperation of associations of employees of States, municipalities, and their agencies to protect themselves against retroactive application of any Federal taxation on salaries; and

Whereas the Maine Water Utilities Association, recognizing the necessity of militant opposition to the proposed legislation, has made contribution to said Conference on State Defense (thereby endorsing its objectives) to further assist in putting over its program; now be it

Resolved, That the Maine Water Utilities Association, in regular meeting assembled, desires our representatives in the national Congress; to support legislation to prohibit retroactive Federal taxes on past year's salaries of employees of the State, municipalities, or their agencies;

To oppose Federal taxation, whether by statute or constitutional amendment, of the revenues or outstanding obligations of the State, municipalities, or their agencies; to endeavor to defeat proposed Federal taxation of future issues of bonds by the State, municipalities, or their agencies; to oppose each, every, and all measures that are calculated to or may have the effect of destroying the traditional dual form of government and jeopardize the integrity of State sovereignty; and be it further

Resolved, That the security is hereby directed to forward copies of the above resolution to the Senators and Congressmen from Maine with the request of the Maine Water Utilities Association they support the objectives regarding taxation and stand firm for the principle of State sovereignty and independence.

Harold E. Weeks,
J. W. Randlette,
Thomas H. Bodge,
Committee.

Municipal Lighting Association of Massachusetts

RESOLUTION ADOPTED JANUARY 26, 1939, AT BOSTON

Whereas the decision of the Supreme Court of the United States, in the case of *Helvering* vs. *Gerhardt* has made possible the retroactive liability of State and municipal employees, for Federal income taxes on salaries received during the past 12 years, and,

Whereas the retroactive assessment of Federal income taxes on State and municipal employees would constitute a grievous hardship and injustice, and,

Whereas the Conference on State Defense has been organized to support legislation proposed in the Green-McCormack bill, H. R. 1791 and Senate bill S. 554, which, if enacted, would prohibit such retroactive assessment: Now, therefore, it is

Resolved, That the Municipal Lighting Association of Massachusetts endorses the objectives of the Conference on State Defense and is opposed to the program of taxation of State and municipal revenues and the retroactive assessment of Federal income taxes on State and municipal employees as proposed by the Treasury Department, and it is further resolved that this resolution be entered in the records of the association and a copy of same be sent to the Conference on State Defense, room 276, Mayflower Hotel, Washington, D. C.

Edward A. Logan, *President.*
Andrew F. Pope, *Secretary.*

NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

Whereas a certain study entitled "Taxation of Government bondholders and employees, the immunity rule and the sixteenth amendment," forwarded by the Department of Justice to the Treasury Department on June 24, 1938, asserts a supreme power in the Central Government to tax the States without their consent, while denying any reciprocal power in the States to tax the Federal Government; and

Whereas the Department of Justice has also asserted that revenues of the States are subject to the Federal corporate income tax levies; and

Whereas it is the sense of this association that such a Federal attack would place the States in the status of counties or provinces of a central government, and would in effect destroy the form of State and local government, and of dual sovereignty, under which the people of the United States have lived and prospered for over a century and a half; and

Whereas the attorneys general of the respective States have a duty to protect the sovereign rights of the States. Now, therefore, be it

Resolved, That the National Association of Attorneys General denies the constitutionality of any attempt by the Federal Government to tax the revenues of the States, or the exercise of their fiscal powers, without the consent of the States first obtained through proper constitutional process; and be it further

Resolved, That the association hereby endorses the program and objectives of the Conference on State Defense in its campaign to place these issues before the people of the States and their representatives; and be it further

Resolved, That the secretary of the association be directed to forward a certified copy of this resolution to each of the six Senators comprising the membership of the Senate Committee appointed pursuant to Senate Resolution No. S. 303, and certified copies also to the chairman of the Senate Finance Committee and the chairman of the House Ways and Means Committee.

[From Detroit Legal News, Wednesday, January 11, 1939]

[Common Council (official)]

DETROIT, Tuesday, January 10, 1939.—The council met and was called to order by the president, Hon. Edward J. Jeffries, Jr.

Present: Council Breitmeyer, Dingeman, Ewald, Kronk, Lodge, Smith, Sweeny, and the president—8.

There being a quorum present, the council was declared to be in session.

The journal of the preceding session was approved.

FROM THE MAYOR

JANUARY 5, 1939.

To the Honorable the Common Council:

GENTLEMEN: The United States Department of Justice recently reported on "the immunity rule and the sixteenth amendment" to the Treasury Department. This report concludes that the Federal Government has the power to tax all State and municipal bonds, both outstanding and future issues, and to tax the salaries of all State and municipal officers and employees earned in the past as well as the future.

The Department of Justice takes the position that a constitutional amendment is not necessary for the Federal Government to impose a tax on States and municipalities; that a congressional act is all that would be required.

There has been some indication such a plan may be introduced in the current session of Congress.

I am of the opinion taxation of State and Federal bonds would upset not only the financial structure of communities such as Detroit, but of the Nation, affecting State and municipal credits, individual investors, as well as corporations and particularly insurance-company investments which represent investments both large and small of nearly everyone in the country.

I am further of the opinion that were an income tax made retroactive on salaries of municipal officers and employees, it would be practically ruinous to those workers who have struggled through the depression.

Tax legislation as I have described, would be a distinct menace to our citizens.

Consequently, I am recommending we vigorously oppose any such Federal legislation. I am submitting for the earnest consideration of your honorable body, a proposed resolution which I am of the firm belief should be passed.

Respectfully yours,

RICHARD W. READING,
Mayor.

JANUARY 6, 1939.

To the Honorable the Common Council:

GENTLEMEN: Subsequent to the drafting of the resolution which I submitted to your honorable body under date of January 5, in regard to possible Federal taxation of State and municipal bonds and salaries, I received the enclosed self-explanatory letter from Mr. Paul V. Betters, executive director of the United States Conference of Mayors.

Mr. Betters points out a special Senate committee will probably initiate hearings on this matter on January 16. Mr. Betters requested a statement from me on this matter, a copy of which I am enclosing for your information.

Incidentally, the communication from the United States Conference of Mayors is additional reason, in my estimation, for favorable action on the resolution which I previously submitted for the consideration of your honorable body.

Respectfully yours,

RICHARD W. READING,
Mayor.

(By Councilman Dingeman)

Whereas it has been proposed that Congress enact a statute attempting to levy an income tax upon municipal securities; and

Whereas Federal taxation by act of Congress of the income on bonds of the city of Detroit would materially increase the cost of municipal financing and seriously embarrass the orderly progression of its refunding program; and

Whereas during recent months it has been asserted that a Federal power to tax the revenues of State and municipal instrumentalities exists, founded upon the theory that the Central Government has the supreme power to tax the States; and

Whereas the taxation by the Federal Government of the revenues of municipalities would seriously threaten their existence and is contrary to the basic system of established government in the United States; and

Whereas as a result of a recent decision of the Supreme Court of the United States, State and municipal employees may be subject to the payment of Federal income taxes, retroactive on salaries earned from 1926 to date; and

Whereas retroactive taxation has always been regarded as contrary to American principles of government, grossly unfair and inequitable: Now, therefore, be it

Resolved, That the city of Detroit is strongly opposed to the taxation of State and municipal securities by the Federal Government unless the consent of the State is first obtained by a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting any Federal taxation of State and municipal revenues other than bonds; and be it further

Resolved, That the city of Detroit hereby urges its Senators and Representatives in Congress to support legislation prohibiting retroactive Federal taxation upon the salaries of State and municipal officers and employees; and be it further

Resolved, That the corporation counsel and controller of the city are directed to cooperate in every manner possible with the efforts now being made by various organizations in furtherance of the foregoing objectives; and be it further

Resolved, That the clerk be, and he hereby is, instructed to forward certified copies of this resolution to the Senators and Representatives of this State in Congress.

Adopted as follows:

Yeas: Councilmen Breitmeyer, Dingeman, Ewald, Kronk, Lodge, Smith, Sweeny, and the president—8.

Nays: None.

RECONSIDERATION

Councilman Kronk moved to reconsider the vote by which the resolution was adopted.

Councilman Dingeman moved to suspend rule 23, except amendment as adopted May 8, 1938, for the purpose of indefinitely postponing the motion to reconsider, which motion prevailed as follows:

Adopted as follows:

Yeas: Councilmen Breitmeyer, Dingeman, Ewald, Kronk, Lodge, Smith, Sweeny, and the president—8.

Nays: None.

Councilman Ewald then moved that the motion to reconsider be indefinitely postponed, which motion prevailed.

The regular order was resumed.

FARGO, N. DAK.

Following is a copy of a resolution which has been adopted by the Board of Commissioners of the City of Fargo, N. Dak.:

Commissioner Olsen offered the following resolution and moved its adoption:

Be it resolved by the Board of Commissioners of the City of Fargo, That the Board of Commissioners of the city of Fargo, N. Dak., does hereby go on record as opposed to and condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities, and any attempt to tax State or municipal bonds, or the salaries of State and local governmental employees, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our Representatives in Congress, urging them to do all in their power to carry out our wishes.

Second by Fuller. On the vote being taken on the question of the adoption of the resolution Commissioners Sutherland, Corrigan, Sheffield, Fuller, and Olsen all voted "aye."

Absent and not voting, none.

Nays, none.

Whereupon the president of the city commission declared the resolution to have been duly passed and adopted.

CARLO JORGENSON,
City Auditor of the City of Fargo, N. Dak.

MACOMB, ILL.

Whereas this body is of the opinion that the placing of a Federal tax upon municipal revenues and municipal securities, or the income therefrom, would considerably add to the cost of city government; and

Whereas this body feels that the retroactive application of any Federal tax upon the income of municipal officers or employees would be unfair and burdensome to them, in view of the fact that their income from the city has been relatively small; and

Whereas this body is of the opinion that any future Federal taxation upon the income of municipal officers or employees would necessitate increasing their salaries and thereby would burden the city government with additional cost: Therefore be it

Resolved by the City Council of the City of Macomb, Ill., That this body is opposed to any Federal taxation of municipal revenues and municipal securities, or the income therefrom; be it further

Resolved, That this council is opposed to the placing of any Federal tax, either applied retroactively or in the future, upon the income of municipal officers or employees; be it further

Resolved, That this body is in accord with the objectives of the Conference on State Defense and hereby expresses its support of the work being done by that conference in connection with these Federal taxation matters; be it further

Resolved, That copies of this resolution be submitted to said conference and to our Congressman from this district.

Adopted December 19, 1938.

STATE OF ILLINOIS,
McDonough County, ss:

I, Harry R. Sapp, the duly elected, qualified, and acting city clerk of the city of Macomb, Ill., do hereby certify that the foregoing is a true and correct copy of a certain resolution adopted by the city council of said city at a regular meeting thereof held on the 19th day of December 1938 as fully and completely as the same now appears of record in the minutes of said meeting; that the original of said resolution and said record are now in my custody and that I am the lawful keeper of the same.

Given under my hand and the official seal of said city this 6th day of January 1939.

[SEAL]

HARRY R. SAPP,
City Clerk.

THE STATE PORT AUTHORITY OF VIRGINIA,
Norfolk, Va., December 13, 1938.

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved by the State Port Authority of Virginia, That congressional legislation should be passed at the next session of Congress, limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the State Port Authority of Virginia is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That certified copies of this resolution be sent to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and also to Senators Glass and Byrd, of Virginia, to the Representatives in Congress of the State of Virginia, and to the Governor and the Attorney General of Virginia.

Adopted this 13th day of December 1938 in session at Norfolk, Va.

THE STATE PORT AUTHORITY OF VIRGINIA.
J. SCOTT PARRISH, *Chairman.*

Certified copy:

W. A. COX, *Director of the Port.*

LAKELAND, FLA.

Be it resolved by the City Commission of the City of Lakeland, Fla., That we go on record as condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax the State or municipal bonds or the salaries of State or local governmental employees unless and until the consent of the State is first obtained through a proper constitutional amendment; be it further

Resolved, That copies of this resolution be sent to United States Senators C. O. Andrews and Claude Pepper and to Representative J. Hardin Peterson, urging them to do all in their power to defeat any attempt on the part of the Federal Government and its various departments to further burden the States and their political subdivisions by further taxing them or their employees.

Passed and approved as to passage, this the 6th day of January, A. D., 1939.

[SEAL]

T. D. CONTNER,
Mayor-Commissioner.

Attest:

J. L. DAVIS, *City Clerk.*

Approved as to form and correctness:

A. R. CARVER, *City Attorney.*

NORWALK

Resolved by the council of the city of Norwalk, That it be the sense of this board that we oppose any attempt upon the part of the Federal Government to tax the revenues of the several States of the United States, or their municipalities, or to place a tax upon municipal bonds unless and until the legal consent of the State so affected, or the State in which such municipality be located be first obtained; be it further

Resolved, That a copy of this resolution be forwarded to the Honorable A. V. Donahey, United States Senator and the Honorable Chas. P. Taft, United States Senator Elect and the Honorable Dudley White, Congressman from the Thirteenth District.

Passed December 20, 1938.

H. P. LINT, *Mayor, Norwalk.*

DES MOINES, IOWA

Be it resolved, by the city council of the city of Des Moines, Iowa:

1. That this council be recorded as opposing the collection by the Federal Government of income taxes for any past period for either State, county, or municipal officials or employees, for the reason that we believe it is un-American to enforce any provision of law which no one contemplated for any past period of time.

2. That the opposition of this council be also recorded to any attempt by the Federal Government to tax all State and municipal bonds, thus increasing interest costs up to 25 percent over what they are now, for the reason that this would tend to destroy all hope for the betterment of the conditions of the taxpayer. Should bond exemptions be ended both as to State and Federal bonds it should not be done at the expense of the States and municipalities and their employees to the sole advantage of the Federal Government. There should be true reciprocity in any movement to tax State and Federal bonds.

3. That opposition to taxation of State and Federal bonds is hereby recorded by this council for the further reason that this city has both police and fire pension funds that would be jeopardized by the taxation of outstanding public securities.

4. That the opposition of this council be also recorded against the taxation by the Federal Government of income of municipalities or other agencies or utilities to pay an actual corporate income tax upon their revenue receipts for the reason that the same would increase the burden of taxation on its already overburdened citizens.

5. That in our opinion the taxation of State and municipal securites should never be permitted until such time as the States have the right to tax Federal securities. As a governmental unit of the State, in recognising the sovereign right of the State, we contend that the taxation of the income thereof would be an encroachment upon the sovereign right.

6. That this council be recorded as favoring an act of Congress at its next session to prevent the retroactive application of any Federal tax upon employees of States and their municipalities.

7. That the opposition of this council be recorded against any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment, guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions and agencies.

8. And that finally we urge upon Congress to preserve the balance of power between the Central Government on the one hand and the States and municipalities on the other.

Moved by Conkling to adopt.

Form approved.

SAM OREBAUGH,
Assistant City Solicitor.

Approved December 19, 1938.

MARK L. CONKLING, *Mayor.*

I, Rex Ramsay, city clerk of said city, hereby certify that at a meeting of the city council of said city of Des Moines, held on the above date, among other proceedings the above was adopted.

In witness whereof, I have hereunto set my hand and affixed my official seal the day and year first above written.

[SEAL]

REX RAMSAY, *City Clerk.*

AMERICAN ASSOCIATION OF PORT AUTHORITIES

RESOLUTION NO. XXXI

Be it resolved by the members of this association from the United States in convention assembled:

1. That the American Association of Port Authorities oppose the taxation by the Federal Government of securities thereafter issued by the States, their municipalities or agencies, unless the consent of the States is first obtained through a constitutional amendment; and then only provided that said constitutional amendment will prohibit the taxation of outstanding securities and Federal taxation of the revenues of the States, their municipalities or agencies, and will permit the reciprocal taxation of Federal securities by the States.

2. That congressional legislation should be adopted at the next session of the Congress of the United States expressly limiting any taxation of the salaries of officers and employees of the States, their municipalities or agencies, to salaries which they receive in the future.

3. That the foregoing objectives of the conference on State defense are hereby endorsed; and the law and legislation committee is hereby authorized to cooperate with the said conference in presenting the views of this association before said Senate committee.

4. The secretary of the association is hereby directed to send a copy of this resolution to each and every one of the Representatives and Senators of the Congress of the United States, from each State in which there is a corporate member of this association; and to the chairman and members of the Senate Finance Committee, and the chairman and members of the House Ways and Means Committee.

PASADENA, CALIF.

(Introduced by Director Robert E. Dawson)

RESOLUTION NO. 6670

A resolution of the board of directors of the city of Pasadena urging Representatives in Congress to oppose retroactive taxes upon income from municipal bonds and salaries, and opposing extension of Federal power relative thereto unless local power relative thereto may be reciprocal

Whereas concerted efforts are now being made to subject to Federal taxation the income from municipal bonds and the salaries of municipal employees, and to give such taxation retroactive effect; and

Whereas the taxation of income from municipal bonds would inevitably result in increasing the cost of local government and, insofar as retroactive, would work a serious injustice to persons who paid a higher price for such bonds, relying upon their exemption from taxation than they otherwise would have paid; and

Whereas the retroactive taxation of the income of municipal employees would be financially ruinous and unfair to those employees and injurious to the communities in which they reside: Now, therefore, be it

Resolved by the Board of Directors of the City of Pasadena: (1) Condemn as unfair, oppressive, and un-American the imposition of retroactive taxes upon the income from municipal bonds and municipal salaries;

(2) Condemn the unwarranted extension of Federal power and the weakening of local government through the taxation of income from municipal bonds to be issued in the future;

(3) Urge that if equitable and nonretroactive taxation of the income from municipal salaries hereafter be contemplated, such taxation be authorized only on the condition that the State be afforded the reciprocal right to tax income from Federal salaries and from Federal securities;

(4) Are convinced that the radical change in relationship between local and Federal Government that is inherent in current efforts to tax municipal securities and salaries should be accomplished only by sanction of the people as a whole, expressed through well considered amendment of the constitution, and not by judicial lawmaking: Be it further

Resolved, That we hereby urge our Representatives and Senators in Congress to carefully consider the views herein expressed, and to lend their constant support to all proper legislative means for carrying them into effect, and the city clerk is hereby instructed to transmit immediately a copy of this resolution to United States Senator Hiram W. Johnson, Senator Elect Sheridan Downey, and Representative in Congress J. C. W. Hinshaw.

The city clerk shall certify to the adoption of this resolution.

I hereby certify that the foregoing resolution was adopted by the board of directors of the city of Pasadena at its meeting held November 29, 1938, by the following vote:

Ayes: Directors Brenner, Dawson, Hamill, Nay, Riccardi, Stewart, Wopschall.

Noes: None.

BESSIE CHAMBERLAIN,
City Clerk.

Signed and approved this 29th day of November 1938.

EDWARD O. NAY,
Chairman of the Board of Directors of the City of Pasadena.

I hereby certify that the foregoing document is a full, true, and correct copy of Resolution No. 6670, on file in the office of the city clerk of the city of Pasadena.

[SEAL] BESSIE CHAMBERLAIN, *City Clerk.*

Approved:

C. W. KOINER, *City Manager.*

Approved as to form this 19th day of November 1938.

HAROLD P. HULS, *City Attorney.*

OFFICE OF THE BOARD OF SUPERVISORS OF THE COUNTY OF LOS ANGELES, STATE OF CALIFORNIA,
Tuesday, August 23, 1938.

The board met in regular session. Present: Supervisors Roger W. Jessup, chairman, presiding; Gordon L. McDonough, John Anson Ford, and L. M. Ford; and L. E. Lampton, clerk, by Mame B. Beatty, deputy clerk. Absent: Supervisor H. C. Legg.

In re proposed plan of Federal Government to tax bonds and securities of States and local governmental agencies and income of their employees: Resolution endorsing program of "Conference on State Defense" to oppose. On motion of Supervisor McDonough, duly carried (Supervisor John Anson Ford voting "no"), it is ordered that the following resolution be, and the same is hereby adopted, to-wit:

Whereas our attention has been called to the proposed plan of the Federal Government to collect income taxes from the employees of States, counties, municipalities, and other local public agencies, and also to collect taxes on bonds and other securities issued by, and the revenues of such local public agencies; and

Whereas the employees of the county of Los Angeles and of the Los Angeles County Flood Control District are engaged solely in governmental work, and that neither the said county nor district has authority to engage in any work of a private or proprietary nature; and

Whereas the taxing of the bonds and securities of the county of Los Angeles and the Los Angeles County Flood Control District might seriously impair the credit of the said county and district, and the taxation of their 15,000 employees retroactively in the manner proposed would cause hardship and distress; and would, in the opinion of this board, impair the efficiency of such employees: Now therefore be it

Resolved, That the board of supervisors of the County of Los Angeles, and ex-officio the board of supervisors of the Los Angeles County Flood Control District, do hereby approve and endorse the program and objectives of the Conference on State Defense, to oppose the proposed plan of the Federal Government to tax the bonds and securities of the States and local governmental agencies and the income of their employees, without the consent of the States first obtained through proper constitutional process; be it further

Resolved, That a certified copy of this resolution be forwarded to the Senators and Congressmen representing the State of California, to the Attorney General of the United States, to the attorney general of the State of California, to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and to the Conference on State Defense, 111 Eighth Avenue, New York City.

The foregoing resolution was adopted by the board of supervisors of the county of Los Angeles and the board of supervisors of Los Angeles County Flood Control District, State of California, on August 23, 1938, and is entered in the minutes of said boards.

[SEAL] L. E. LAMPTON,
County Clerk of the County of Los Angeles, State of California, and ex-officio Clerk of the Board of Supervisors of said County.
By MAME B. BEATTY, *Deputy.*

ASSOCIATION OF COUNTY ASSESSORS OF THE STATE OF CALIFORNIA

Whereas our attention has been called to the proposed plan of the Federal Government to collect income taxes from the employees of States, counties, municipalities, and other local public agencies, and also to collect taxes on bonds

and other securities issued by, and the revenues of, such local public agencies; and

Whereas the taxing of the bonds and securities, and of the revenues of the States, counties, municipalities, and other local public agencies might seriously impair the credit of the said States, counties, municipalities, and other local public agencies, and the taxation of their employees retroactively in the manner proposed would cause hardship and distress; and would, in the opinion of this association, impair the efficiency of such employees; Now, Therefore, be it

Resolved, That the Association of County Accessors of the State of California do hereby approve and endorse the program and objectives of the Conference on State Defense, to oppose the proposed plan of the Federal Government to tax the bonds and securities, and the revenues, of the States and local governmental agencies and the income of their employees, without the consent of the States first obtained through proper constitutional process; be it further

Resolved, That a certified copy of this resolution be forwarded to the Senators and Congressmen representing the State of California, to the Attorney General of the United States, to the Attorney general of the State of California, to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and to the Conference on State Defense, 111 Eighth Avenue, New York City.

JOLIET PARK DISTRICT, ILL.

Resolved by the Commissioners of the Joliet Park District, That it be the sense of this board that we oppose any attempt upon the part of the Federal Government to tax the revenues of the several States of the United States, or their municipalities, or to place a tax upon municipal bonds unless and until the legal consent of the State so affected, or the State in which such municipality be located be first obtained; be it further

Resolved, That a copy of this resolution be forwarded to the Honorable J. Hamilton Lewis and the Honorable Scott W. Lucas, United States Senators for the State of Illinois, and the Honorable Chauncey W. Reed, Representative in Congress for the Eleventh Congressional District.

STATE OF ILLINOIS,
County of Will, Joliet Park District, ss.:

I, Glenn G. Paul, do hereby certify that I am the duly appointed, qualified, and acting Secretary of Joliet Park District, and as such secretary I am the custodian of the records and of its corporate seal.

I do further certify that on the 28th day of November A. D. 1938, the board of commissioners of Joliet Park District duly convened in postponed regular session, and at such meeting the board duly adopted a resolution relating to any attempt of the Federal Government to tax the revenues or bonds of municipalities.

I do further certify that the copy of said resolution hereto attached is a true, full, and complete copy thereof as the same appears on said records of said district.

In testimony whereof I have hereunto set my hand and seal of Joliet Park District this 2d day of December A. D. 1938.

(SEAL)

GLENN G. PAUL,
Secretary of Joliet Park District.

COUNTY AUDITOR'S OFFICE,
St. Paul, Minn., December 9, 1938.

The attention of Senator Henrik Shipstead, Senator Ernest Lundeen, the Honorable Melvin J. Maas, is respectfully called to the following resolution of the board of county commissioners of Ramsey County, Minn., adopted at the meeting held on the 5th instant.

(By Commissioner Moeller)

Resolved by the Board of County Commissioners of Ramsey County, Minn., That we go on record as condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds or the salaries of State and local governmental employees, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our Representatives in Congress, urging them to do all in their power to carry out our wishes.

EUGENE A. MONICK, *County Auditor.*

NEWPORT NEWS, VA.

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and,

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies; now, therefore, be it

Resolved by the Council of the City of Newport News, That congressional legislation should be passed at the next session of Congress, limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the city of Newport News is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That certified copies of this resolution be sent to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and also to Senators Carter Glass and Harry Flood Byrd, and to the Representatives in Congress from the State of Virginia.

Passed by the Council of the City of Newport News, November 14, 1938.

B. G. JAMES, *President.*

[SEAL] A. M. HAMILTON, *City Clerk.*

A true copy, teste: A. M. HAMILTON, *City Clerk.*

CHAMBER OF COMMERCE OF THE STATE OF NEW YORK

FEDERAL TAXATION OF TAX-EXEMPT SECURITIES OPPOSED

To the Chamber of Commerce.

The committee on taxation offers the following resolutions:

Resolved, That the Chamber of Commerce of the State of New York reaffirms its action of February 1, 1923, opposing any "amendment of the Constitution of the United States which shall disqualify either the Federal Government or any State or municipal government from issuing bonds free from both Federal and State taxation, as uneconomic and contrary to the interests both of the Federal Government and of the States and municipalities and of the taxpayers in both jurisdictions, and particularly disadvantageous to the State, their municipalities and their citizens, which now collect their taxes through an income-tax law"; and be it

Resolved, That the chamber again reaffirms its belief

(1) That capital is not withdrawn from industry by the issue of tax exempt Government securities;

(2) That Government spending will not be curbed by the removal of tax exemptions as Government bonds will still have the preference and a lower interest rate than private corporation bonds;

(3) That Government bonds free of tax, the proceeds of which are spent for usual Government purposes, do not constitute unfair competition with bond issues of private corporations;

(4) That the rich men who escape taxation by owning tax exempts are so few in number that the additional Government revenue to be obtained by taxation would be insignificant; and

(5) That any increase in the interest burden of governmental units by removing tax exemption will increase by that much the burden of taxation, and all our people will directly or indirectly be affected; and be it

Resolved, That the chamber believes that Federal legislation to remove the existing laws on exemptions will result in dangerous concentration of power in the Federal Government and the possibility of serious impairment of the sovereignty of States and their subdivisions like counties, towns, villages, etc.; and be it further

Resolved, That copies of this report be sent to the President, the Members of Congress, chambers of commerce and others interested.

This chamber went on record almost 16 years ago against any removal of the tax exemption enjoyed by Government securities issued by the Federal and State Governments and their subdivisions. The question was considered at great length by committees of the chamber for several months, and a long report was presented and adopted at the regular monthly meeting February 1, 1923. The various arguments in favor of taxing these securities were carefully considered. It was pointed out that it was a mistake to consider capital was withdrawn from industry as a result of tax exemption. The proceeds of Government bonds are obviously spent in wages, materials and structures, just as in the case of industrial bonds. Even though the rich buyer of tax exempts withdraws from active business, his money is not withdrawn. The course of business activity in the past shows that the increase in the number of tax-exempt bonds did not impair the productivity or the prosperity of the country or dry up the sources of revenue.

Furthermore, there is no evidence that the removal of tax exemptions and the resulting higher interest rates will deter the various Government units from spending money or being extravagant. Legislative bodies in making appropriations give comparatively little consideration to the price at which bond issues must be sold or the subsequent increase in taxation. The members of these bodies are largely actuated by other motives than rates of interest.

As was pointed out by this chamber in 1923, tax-free bonds do not make unfair competition with trade borrowers. "The competition would be the same whether the Government bonds are taxable or free of tax. If taxable, the rate of interest will have to be increased, and the rate on railroad, industrial and other corporate bonds will go up correspondingly. The Government bonds will have the preference and there will be approximately the same difference between such bonds and corporation bonds generally, whatever the rate is on the Government bonds."

Your committee on taxation believes that it is an unsound allegation, the same as in 1923, that an important number of rich men are escaping taxation by investing in Government securities. The Division of Research and Statistics of the Treasury Department under date of August 1938 issued a detailed study of securities wholly or partly exempt from Federal income taxes. The gross volume of these as of June 30, 1937, was $65,648,000,000. This sum included about $15,126,000,000 held by governments, their sinking funds, trust and investment funds, their agencies and Federal Reserve banks, leaving approximately $50,522,000,000 outstanding in the hands of non-Government owners. Banks were the most important corporate owners, their ownership amounting to $20,916,000,000, or 41 percent of the amount in the hands of nongovernmental bodies.

The detailed study gives figures from income-tax returns for 1935. These figures show that individuals with incomes of $5,000 or more owned $2,063,000,000 of Federal securities, and $2,562,000,000 of State, local, territorial, and insular securities, a total of $4,625,000,000. Those with incomes of more than $100,000 owned 26.7 percent of this total, or less than $1,235,000,000, which is less than 2 percent of the gross volume of tax-exempt securities outstanding. The total ownership of all individuals with income of $5,000 or more is less than 7.3 percent. In the opinion of your committee this ownership is far too small to warrant a radical change in our taxation system; particularly a change which threatens an undermining of our democracy and our Constitution.

In the last decade a radically new idea of the purpose and use of taxes has been developed. For many generations previously taxes were largely levied for revenue purposes only. Now they are being levied in a large way as an instrument of economic planning and social control. A recent study by tax experts outlines the following examples: (1) To finance subsidies that are granted in order to encourage and control private activities; (2) to exert pressure upon the activities of individuals and business concerns; (3) to redistribute wealth and income in order to offset an undesirable distribution caused by the economic system. So numerous are punitive taxes now being levied, that many believe they are the main bar to prosperity.

A termination of the tax exemption of Government securities would accentuate the power of the Federal Government to strip the States of their sovereignty and create a Federal dictatorship, not only over business and individual activities, but over the functions carried on by our 48 States. It is obvious therefore that

more reason exists today than in 1923 for opposing the removal of the tax exemption feature of Government securities.

The administration at Washington has publicly announced on several occasions that Congress now possesses power under the sixteenth amendment to tax Government securities. In the President's message to Congress of April 25, 1938, he said:

"The sixteenth amendment to the Constitution of the United States, approved in 1913, expressly authorized the Congress 'to lay and collect taxes on incomes from whatever source derived.' That is plain language. Fairly construed, this language would seem to authorize taxation of income derived from State and municipal as well as Federal bonds and also income derived from State and municipal as well as Federal offices.

Other members of the administration have made similar statements. Thus it is that the Federal Government, for the first time in its history, is now asserting the complete power to tax the States. A study issued by the Department of Justice, June 24, 1938, declares the Federal Government to be supreme in the taxing field, and "the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated, and supreme, taxing power of the Central Government."

However, the United States Supreme Court so far has not taken this view of the sixteenth amendment. In a brief prepared for the Ways and Means Committee in 1923, A. W. Gregg, Assistant to the Secretary of the Treasury, declared "that a tax cannot be levied upon the income derived from State and municipal securities or securities issued by any political subdivision of a State without provision being made therefor by a constitutional amendment; or, in other words, that under the decisions of the Supreme Court such a tax is now inhibited by the Constitution."

Many Supreme Court decisions to this effect were cited by Mr. Gregg. He also gave the following quotation from *Evans* v. *Gore* (1920), 253 U. S. 245:

"True, Governor Hughes, of New York, in a message laying the amendment before the legislature of that State for ratification or rejection, expressed some apprehension lest it might be construed as extending the taxing power to income not taxable before; but his message promptly brought forth statesmen who participated in proposing the amendment such convincing expositions of its purpose, as here stated, that the apprehension was effectively dispelled and ratification followed.

"Thus the genesis and words of the amendment unite in showing that it does not extend the taxing power to new and excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another. And we have so held in other cases."

The reasons for the sixteenth amendment were provisions in the Federal Constitution that direct taxes must be apportioned among the States in proportion to their population, determined by the last Federal census; and that taxes other than direct taxes must be levied uniformly throughout the United States. These provisions rendered it impractical to levy a tax upon income derived from invested capital, the Supreme Court having held that a tax levied upon the income derived from real estate or personal property, was a direct tax which required apportionment among the States, as the Constitution required.

The entire history of this amendment indicates that it was subject to the implied limitation that Congress can levy taxes only upon persons, properties, and business subject to its taxing jurisdiction; and the States of the Union have never been subject to the taxation jurisdiction of Congress.

The taxation of tax-exempt securities was discussed by David M. Wood at the convention of the Investment Bankers Association, October 20, 1938. Among other things, he stated:

"If the sixteenth amendment, however, be considered as a grant of a new power to Congress, then it authorizes a levy of a direct tax without the necessity of apportioning it among the States. At the same time it is not subject to the rule of uniformity, as that rule does not apply to direct taxes. It is, therefore, subject to no limitation. Under that interpretation of the sixteenth amendment, Congress would possess the power to levy a tax upon incomes derived from invested property subject neither to the rule of apportionment, nor to the rule of uniformity. The result would be that Congress would possess the power to levy income taxes of this character at different rates in the different States. It could tax incomes,

derived from invested property, at one rate in New York, and in Nevada, at another rate. This was pointed out by Chief Justice White in an opinion rendered for a unanimous court in *Brushaber* v. *Union Pacific R. R.*, 240 U. S. 1, at page 12."

As the power to tax is the power to destroy, it was pointed out to the investment bankers that the administration's view of the sixteenth amendment meant that "it would be possible for Congress to tax out of existence invested capital throughout the entire country, or, there being no limitation of the taxing power, * * * to select the States in which invested capital should be taxed out of existence." Furthermore, Congress could so exercise the taxing power against judicial officials of the country, as to make them subservient to Congress, and if Congress were dominated by the Executive, to make both the Judiciary and States subservient to the Executive branch of the Government. Thus the power would lie in the Federal Government to destroy the States and also to destroy the independence of the Judiciary. Elections could be controlled and other objectives attained by placing higher tax levies in those States which were not subservient to the Federal Government. The States would cease to be sovereignties. Undoubtedly the States, when ratifying this amendment, did not intend to create such a possibility; or "to destroy limitations upon the powers of the Federal Government, which are expressly provided for in the Constitution, or necessarily implied, and which are essential for the preservation of the very form of Government which the Constitution was intended to establish."

In the case of *Charles C. Steward Machine Company* v. *Davis*, 301 U. S. 548-616 (1938), Justice Sutherland said:

"The people of the United States, by their Constitution, have affirmed a division of internal governmental powers between the Federal Government and the governments of the several states—committing to the first its powers by express grant and necessary implication; to the latter, or to the people, by reservation, 'the powers not delegated to the United States by the Constitution, nor prohibited by it to the States.' The Constitution, thus affirms the complete supremacy and independence of the state within the field of its powers."

In the same case Justice McReynolds said:

"In *Texas* v. *White*, 7 Wall., a cause of momentous importance, this Court, through Chief Justice Chase declared: 'But the perpetuity and indissolubility of the Union by no means implies the loss of distinct and individual existence, or of the right of self-government by the States. Under the Articles of Confederation each State retained its sovereignty, freedom, and independence, and every power, jurisdiction, and right not expressly delegated to the United States. Under the Constitution, though the powers of the States were much restricted, still, all powers not delegated to the United States, nor prohibited to the States, are reserved to the States, respectively, or to the people. * * *

"The doctrine thus announced and often repeated, I had supposed was firmly established. Apparently the States remained really free to exercise governmental powers, not delegated or prohibited, without interference by the Federal Government through threats of punitive measures or offers of seductive favors."

In view of these various considerations, your committee on taxation believes that this chamber should vigorously oppose legislation by Congress or a constitutional amendment which would remove the present tax exemption on Government securities.

Respectfully submitted,

JESSE S. PHILLIPS, *Chairman.*

DECEMBER 20, 1938.

NEW YORK STATE ASSOCIATION OF MUNICIPAL ENGINEERS

Whereas the possible effects of current Treasury Department interpretations of recent Supreme Court decisions gravely concern engineers employed by the municipalities, by

(*a*) threatening retroactive taxation of salaries they have received during the past 12 years and which they have assumed to be exempt as a result of previous Supreme Court decisions;

(*b*) by threatening to increase the cost of carrying on municipal government by removing the exemption which municipal revenues and securities have tradi-

tionally enjoyed, and that without the consent of the States through constitutional amendment: Be it

Resolved, By the New York State Association of Municipal Engineers:

First. That the association urge all members of and candidates for both Houses of Congress to support the following bill in Congress at the 1939 session:

"A BILL To prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That any taxes imposed by the Revenue Act of 1936 or prior revenue acts upon any individual in respect of amounts received by him as compensation for personal services as an officer or employee of any State or States or of any political subdivision, or any municipal or public corporate instrumentality or agency thereof (except to the extent that such compensation is paid out of funds of the United States of America), together with any interest or penalties in connection therewith, shall be canceled, abated, credited, or refunded."

Second. That this association invites the cooperation of each of the Congressmen and Senators which represent its membership in the Congress of the United States, to defeat any proposal to impose Federal taxes on State and municipal securities and revenues without the States' consent, and to oppose any program which would increase Federal revenues at the sacrifice of equally necessary municipal government and the type of governmental services which can be performed only by the States and municipalities.

Third. That a copy of this resolution be sent to every Congressman and Senator in the State of New York, with an invitation for his support and a declaration of his position.

AKRON, OHIO

(Offered by Sanderson)

RESOLUTION NO. 847-1938 REQUESTING THE CONGRESS OF THE UNITED STATES TO ENACT LEGISLATION PROHIBITING RETROACTIVE TAXATION OF STATE AND MUNICIPAL EMPLOYEES; TO PREVENT FEDERAL TAXATION OF OUTSTANDING SECURITIES OF STATES AND MUNICIPALITIES AND THEIR AGENCIES; AND TO PREVENT FEDERAL TAXATION OF THE REVENUES OR INCOME OF STATES AND MUNICIPALITIES AND THEIR AGENCIES

Whereas during the course of a century the Constitution of the United States has been interpreted to forbid the taxation by the Federal Government of the employees of the States, and of State instrumentalities, and to forbid the taxation of State and municipal bonds; and

Whereas the Department of Justice, under date of June 24, 1938, submitted a report on "The Immunity Rule and the Sixteenth Amendment" to the Treasury Department, which report concludes that the Federal Government has power to tax all State and municipal bonds, both those outstanding and future issues, and has also the power to tax the salaries of all officers and employees of the States and municipal governments; and

Whereas said report further concludes that the States have no such power to levy a tax upon Federal bonds and Federal salaries; and

Whereas municipal and State employees, by reason of said report, are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926; and

Whereas bonds have been sold on the representation of State and municipal officers, and under existing regulations of the Treasury Department, that they were exempt from Federal taxation; and

Whereas the enforcement by the Federal Government of the conclusions contained in said report would be an injustice upon State and municipal employees and would seriously and injuriously affect the financial standing of the city of Akron and its ability to issue future bonds; and,

Whereas this council has already expressed its sentiment by resolution in favor of the taxation of salaries, accruing and to be earned in the future, upon the same basis as income taxes now are, and may hereafter be levied upon the earnings of other individuals not engaged in public service, and the members of this council are actively opposed to the present policy of granting special privileges and immunities from income tax to public officials generally; now, therefore, be it

Resolved by the Council of the city of Akron:

SECTION 1. That this council respectfully petitions the Congress of the United States at its next session to pass legislation prohibiting the retroactive taxation of State and municipal employees; the prevention of Federal taxation of outstanding securities of States and municipalities and of State and municipal agencies; and the prevention of Federal taxation of the revenues or income of States and municipalities and of State and municipal agencies, and also to enact legislation insuring the collection of income taxes upon future earnings from all municipal, county, State, and Federal employees on the same basis as levied upon the earnings of other individuals generally.

SECTION 2. That a copy of this resolution be forwarded by the clerk of this council to the clerk of the United States Senate, Senate Office Building, Washington, D. C.; to the Clerk of the United States House of Representatives, House Office Building, Washington, D. C.; to Hon. Vic Donahey, United States Senator, Washington, D. C.; to Hon. Robert J. Bulkley, United States Senator, Washington, D. C.; to Hon. Dow W. Harter, Member of the House of Representatives of the Fourteenth Congressional District, Washington, D. C.; and to Conference on State Defense, 111 Eighth Avenue, New York, N. Y.

Passed September 6, 1938.

ROBERT M. SANDERSON,
President of the Council.

J. M. BAUMAN, *Clerk of Council.*

Approved Sept. —, 1938.

———— ————, *Mayor.*

I hereby certify that Resolution No. 347–1938 was not returned by the mayor signed or vetoed within 10 days, nor was he prevented from so doing by the adjournment of council.

J. M. BAUMAN, *Clerk of Council.*

COUNTY OFFICERS ASSOCIATION OF THE STATE OF OKLAHOMA

Whereas the County Officers Association of the State of Oklahoma, being in regular annual session assembled in Oklahoma City on October 1, 1938, has just learned of a decision of the Supreme Court of the United States rendered on May 23, 1938, in the case of *Helvering* v. *Gerhardt et al.* (No. 779–80–81, October term 1937); and it appearing to said association that said decision opens the way to possible retroactive Federal taxation of the salaries of State and municipal employees; and it further appearing that said decision opens the way for possible Federal taxation upon the revenue receipts of States and counties, and it further appearing to the association that said decision opens the way to possible Federal taxation of revenue receipts of municipally owned waterworks, transportation lines, electric power and light plants, sewage plants, and other similar projects; and it further appearing that said decision opens the way to probable Federal taxation of all State and municipal bonds; and it further appearing that the Federal Department of Justice is taking the position that the States have no right of retaliation and no authority in said decision or otherwise to tax Federal securities or Federal salaries; and it appearing to this association, in convention assembled, that such doctrines are and would be inimical to the best interests of the citizens and taxpayers of Oklahoma; and it further appearing that a national organization of the attorneys general is already engaged in petitioning for a rehearing of said cases; and it appearing to this convention that this said decision changes the unbroken law, understanding and practice of the relation between State and Federal authorities existing for more than 100 years and that said decision should not be allowed to stand, unless a constitutional amendment is proposed and submitted by the Congress to the various States, which would have the effect of allowing the States the right to tax Federal incomes and Federal securities; now, therefore, be it

Resolved by the County Officers Association of Oklahoma, in annual convention assembled, That they petition each of our United States Senators from Oklahoma and each of the Oklahoma members of the National House of Representatives to study this case and its affect upon State and municipal financing and upon the claimed Federal right to tax State officials; and that we further petition each member of said delegation to be on the alert to use his influence at all times for the protection of our State against the encroachment of Federal taxation; and further that each member of the delegation be petitioned to work and vote for

and insist upon the submission of a Federal constitutional amendment (in case the Supreme Court allows this decision to stand) which will allow to the several States the reciprocal right to tax Federal securities and the salaries of Federal officials; be it further

Resolved, That the Secretary be instructed to send forthwith to each Senator and Representative of the Oklahoma delegation a certified copy hereof.

CHESTER, PA.

Expressing the opposition of city council to the Federal Government taxing States and municipalities and their officials and employees.

The Council of the City of Chester Does Resolve: That the council of the city of Chester hereby and now desires to go on record as being opposed to the Federal Government taxing bonds and incomes, either of them, of States and municipalities and salaries of public officials and employees neither in the future or retroactively, for the following reasons:

1. Because it would actually establish the power of the Federal Government to compel the States and their agencies to pay an income tax upon their revenues.
2. Because it denies corresponding power in the States to tax the Federal Government except by grace of Federal permission which could be repealed by any subsequent Congress.
3. Because it would establish the power of any subsequent Congress to tax already issued securities of the States and their agencies, although they were sold and paid for at a higher price because of exemption.
4. Because it would increase the cost of State and local government and so add to the burdens of the local taxpayers.
5. Because it would foster overcentralization at the sacrifices of local government and home rule.
6. Because it opens the way for retroactive taxation of all public officers' and employees' back salaries.
7. Taxing the public officers' and employees' back salaries during the period of 12 years would be a very great hardship and would no doubt result in the ruin of many officers and employees, particularly in the lower salary and wage brackets.

And whereas the city clerk be and he is hereby directed to send a certified copy of this resolution to the Pennsylvania United States Senators and the Congressman from this district.

We hereby certify that this resolution passed council this 20th day of December A. D. 1938.

WILLIAM WARD, Jr., *Mayor.*

Attest:

BENJAMIN NEWSOME, *City Clerk.*

SHARON, PA.

RESOLUTION NO. 2483

(Introduced by Mr. Stewart, November 8, 1938. Adopted, November 8, 1938)

A resolution of the council of the city of Sharon, Pa., opposing the Federa taxation of State and Federal revenues and obligations.

Resolved, by the council of the city of Sharon, Pa., That we go on record as endorsing the action taken at the convention of the League of Cities of the Third Class in Pennsylvania, held on September 1 and 2, 1938, in the city of Reading, condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds or the salaries of State and local governmental employees, unless and until the consent of the State is first obtained through a proper constitutional amendment; and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our Representatives in Congress, urging them to do all in their power to carry out our wishes.

Adopted in council this 8th day of November, A. D., 1938.

J. FRED. THOMAS,
Mayor and President of Council.

Attest:

FRED S. WILLIAMS,
City Clerk.

I hereby certify that the foregoing is a true and correct copy of resolution No. 2483 of the city of Sharon, Pa.

FRED S. WILLIAMS,
City Clerk.

MARSHALL, TEX.

Resolved by the city commission of the city of Marshall, Tex., That we go on record as condemning any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities and any attempt to tax State or municipal bonds or the salaries of State and local governmental employees unless and until the consent of the State is first obtained through a proper constitutional amendment, and be it further

Resolved, That copies of this resolution be sent to our United States Senators and to our Representatives in Congress urging them to do all in their power to carry out our wishes.

TEXAS CHAPTER, MUNICIPAL FINANCE OFFICERS' ASSOCIATION

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved by the Texas Chapter, Municipal Finance Officers' Association in convention assembled at Port Arthur, Tex., on the 26th of October 1938—

First. The Federal Government should, under no circumstances be permitted to tax the revenues of local governments or any of their agencies, or the bonds which they have already issued and which are outstanding.

Second. Legislation should be promptly enacted which will prohibit the taxation of the salaries of State and municipal employees, earned in past years, when it was then believed that the said salaries, were exempt.

Third. If the income from future issues of State and municipal bonds are to be taxed, as well as the salaries of local government employees, the Federal Government should accord reciprocal privileges to our city and State Governments applying to Federal securities, salaries, and properties.

Fourth. In the absence of a grant of equal reciprocal taxing powers, our fullest resistance should be given to any attempt on the part of Federal Government to tax the income from either bonds presently outstanding or those issued in the future, or salaries paid either in the past, present, or in the future, unless authorized by a proper constitutional amendment.

Fifth. That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee, and that the same of this resolution be communicated by the respective members of the association to their congressional Representatives as soon as may be.

Passed and approved this the 26th day of October, A. D. 1938, at Port Arthur, Tex.

Approved:

L. L. WILLIAMS,
President, Texas Chapter of the Municipal Finance Officers' Association.

Attest:

E. E. MCADAMS, *Secretary.*

THE INDUSTRIAL COMMISSION OF UTAH

I move that the following resolution be adopted.

B. D. NEBEKER, *Commissioner.*

RESOLUTION NO. 1870

Whereas on April 25, 1938, the President of the United States sent to Congress a message dealing with the possible removal of tax exemptions from bonds issued by Federal, State, and municipal governmental units and removal of tax exemptions on income earned by State governmental employees and others; and

Whereas pursuant to a study of the possibilities mentioned in the President's message, the United States Department of Justice on June 24, 1938, transmitted to the Treasury Department an exhaustive report dealing with the subject of taxation of Government bondholders and employees. It was suggested in said report and it has been proposed by several Members of the United States Congress and by officials of the United States Treasury Department that taxes might be collected from the salaries of State and municipal employees retroactively as far back as the year 1926, and also that Federal taxes might be collected from the income received by holders of State and municipal bonds either with or without Federal legislation in addition to that now existing; and

Whereas some efforts have already been made by officials of the United States Treasury Department to collect the taxes above mentioned under existing legislation, and it appears certain that further efforts will be made to collect such taxes and further efforts will be made by Members of Congress to pass Federal legislation for the purpose of collecting such taxes; and

Whereas while the Industrial commission of Utah is in sympathy with the broad objectives of the President's message to Congress above mentioned, the commission is convinced that it would be unjust for the United States Treasury Department to attempt to make any collections of Federal taxes upon the income of State and municipal employees retroactively, and that it would be unjust and burdensome upon the commission's operation of the State insurance fund of Utah if the United States Treasury Department attempts to collect taxes upon the income of the large amount of municipal bonds held as reserves for the State insurance fund with which to mature claims existing over a long period of years. The commission is further convinced that if the theories of the United States Department of Justice, contained in its report above mentioned, are accepted by the United States Treasury Department and Congress and if said theories are followed to their logical conclusion there is grave danger that an attempt will be made to levy and collect a Federal tax upon the operations of the State insurance fund itself; and

Whereas there has been organized a conference on State defense with its headquarters at 111 Eighth Avenue, New York City, said conference consisting of attorneys general of 39 States of the United States, one of whom is the Honorable Joseph Chez, attorney general of Utah, which conference is a voluntary association having for its main purposes promulgation of information and other similar assistance toward preventing the retroactive taxation of State and municipal employees and the encroachment of the Federal Government's taxation on the operations of State and municipal functions and the prevention of Federal taxation of State and municipal bonds without reciprocal taxation of Federal bonds; and

Whereas it would be for the best interests of the State insurance fund to make a contribution to said conference on State defense to assist in the purposes above outlined: Now, therefore, be it

Resolved, That the sum of $250 be appropriated from the State insurance fund, which sum shall be immediately transmitted to the conference on State defense for use by it in furtherance of the purposes herein mentioned.

[SEAL] CAROLYN I. SMITH, *Secretary.*

Passed by the Industrial Commission of Utah, Salt Lake City, Utah, November 22, 1938.

O. F. MCSHANE,
Chairman Pro Tempore.
CAROLYN I. SMITH,
Secretary.

OFM:RJ

INVESTMENT BANKERS ASSOCIATION OF AMERICA

Whereas proposal has been made to enact Federal legislation to tax the income from State and municipal securities thereafter issued without first submitting the question to the States and obtaining their consent in the form of a constitutional amendment, and

Whereas it is officially contended by the Federal administration that the Federal Government now has that power without amendment to the Constitution, and

Whereas if this contention be enacted into law and judicially sustained the power to tax thereby established might be applied to previously issued and outstanding obligations of States and municipalities and, in the opinion of eminent counsel, might even be asserted and applied to the revenues on which the States and municipalities themselves depend for their existence, and

Whereas regardless of present assurances to the contrary, the power to tax if so established might by a future Congress be applied to the detriment of holders of securities purchased in good faith and to the distress or destruction of the States and municipalities themselves: Now, therefore be it

Resolved by the Investment Bankers Association of America in convention assembled: First, that attention be directed to resolution adopted by its board of governors on May 7, 1920, and standing continuously since then as the expressed policy of the association as follows:

"It is the sense of this Board that the Investment Bankers Association of America advocate the adoption of an amendment to the Constitution of the United States empowering on the one hand the Federal taxation of the income from future obligations of the States and their political subdivisions and on the other hand the taxation of future obligations of the United States by the States and their political subdivisions, in both cases with proper safeguards limiting such taxation."

Second, that this convention supplement such resolution to include the obligations of instrumentalities and agencies of the States and their political subdivisions on the one hand and the instrumentalities and agencies of the Federal Government on the other hand.

Third, that this convention record itself as opposed to any method for the accomplishment of this purpose other than by constitutional amendment.

In addition, examination of the Congressional Record indicates that the following cities have filed resolutions with the House Ways and Means Committee protesting any tax on State and municipal bonds: City of Los Angeles, Calif.; city of Dubuque, Iowa; city of Davenport, Iowa; city of Highland Park, Mich.; city of Ann Arbor, Mich.; city of Oak Park, Mich.

In the third category, we find that by far the largest Nation-wide organization in the field of public employees, the American Federation of State, County and Municipal Employees, which has 48,000 members, is unqualifiedly opposed to the taxation of State and municipal bonds by congressional statute. They state:

The Association opposes any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions and agencies.

The Civil Service Forum of New York City, representing approximately 100,000 civil-service employees, has adopted a similar resolution insisting that the Federal Government, if it is to tax municipal bonds at all, must do so only through constitutional amendment.

Other organizations of public officials and employees who have adopted similar resolutions number more than 100, representing over 300,000 members. Among these organizations are Nation-wide associations of fire chiefs, police chiefs, and other municipal executives as well as associations of public employees representing all divisions of State and municipal service.

A great majority of these resolutions (recognizing the inherent threat to the stability of State and municipal finance contained in the Treasury tax proposals) vehemently oppose the imposition of a Federal levy upon State and municipal bonds unless the States consent is legally obtained through the presentation of a constitutional amendment. These resolutions I will present to the committee without further listing.

(The resolutions referred to are as follows:)

RESOLUTION ADOPTED BY THE INTERNATIONAL ASSOCIATION OF FIREFIGHTERS RE RETROACTIVE TAXATION OF FIREMEN'S SALARIES[1]

Whereas the Federal Department of Justice and the Treasury Department have contended that "the principle of immunity protected the Federal Government against taxation by the States, but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the Central Government;" and

Whereas as a result, firemen employed by the States, counties, and municipalities are threatened with an immediate retroactive liability for Federal income tax on their salaries earned for every year back to 1926; and

Whereas as a further result there is drawn into question the immunity from Federal corporate income tax of the revenues derived by the States, their subdivisions and agencies, taxation of which would derogate State sovereignty and add a crushing burden to the already heavy cost of State and municipal government; and

Whereas the Federal taxing officials have also asserted a constitutional right to add to the cost of State and municipal government by taxing State and municipal bonds while denying to States and their agencies a constitutional guaranty of their right to reduce that added cost by reciprocal taxation of Federal securities: Now, therefore, be it

Resolved, by the International Association of Fire Fighters, in convention assembled this 1st day of September 1938: First, that the association urge all members of and candidates for the both Houses of Congress to support the following bill in Congress at the 1939 session:

A BILL To prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That any taxes imposed by the Revenue Act of 1936 or prior revenue acts upon any individual in respect of amounts received by him as compensation for personal services as an officer or employee of any State or States or of any political subdivision, or any municipal or public corporate instrumentality or agency, thereof (except to the extent that such compensation is paid out of funds of the United States of America), together with any interest or penalties in connection therewith, shall be canceled, abated, credited, or refunded.

Second, that the association opposes any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues already issued, securities of the States, their subdivision and agencies.

Third, that the association cooperate with the Conference on State Defense in furthering the above program, and that the executive committee is hereby given full power and authority to take all steps necessary in connection therewith.

[1] Resolutions identical in form or effect were adopted and submitted by International Association of Fire Chiefs; New England Association of Fire Chiefs; Illinois Firemen's Association; New York State Permanent Firemen's Association; California State Firemen's Association; Central New York Firemen's Association; and Binghampton Firemen's Benevolent Firemen's Association. Locals of the International Association of Firefighters, located in the following cities, adopted and submitted identical resolutions: Cleveland Heights, Ohio; Wenatchee, Wash.; Erie, Pa.; Escanaba, Mich.; McKeesport, Pa.; Mansfield, Ohio; Asbury Park, N. J.; Long Branch, N. J.; Kalispell, Mont.; Covington, Ky.; Logansport, Ind.; Long Beach, N. Y.; Santa Anna, Calif.; and Neenah, Wis. Resolutions opposing retroactive taxation of firemen's salaries were adopted by locals of the International Association of Firefighters located in the following cities: Joliet, Ill.; Decatur, Ill.; Council Bluffs, Iowa; and Irvington, N. J.

RESOLUTIONS AS ADOPTED AT FIRE CHIEFS' MEETING HELD JANUARY 10, 1939

Whereas the Department of Justice of the United States has interpreted recent decisions of the United States Supreme Court as holding that the Federal Government has the supreme power to tax all State and municipal employees, and to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies; and

Whereas the attorneys general of the States recognizing the menace from the Federal Government to impair the sovereignty of their several States and their freedom, and have joined themselves into a Conference on State Defense; and

Whereas the International Association of Fire Chiefs, and the International Association of Fire Fighters, have voted to cooperate with the Conference on State Defense, for their own protection; and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926 with penalties attached: Now, therefore, be it

Resolved, That the State Association of Fire Chiefs of Maine, in convention assembled on the 10th day of January 1939, desires our representatives in Congress, to support legislation to prohibit retroactive Federal taxes on salaries of State and municipal employees, and to endeavor to defeat proposed legislation, to tax State and municipal securities; and be it further

Resolved, That the secretary is hereby directed to forward copies of the above resolution to the Senators and Congressmen from Maine, with a request that they support the objectives of the Conference on State Defense, and stand firm for the principle of State sovereignty and independence.

J. W. RANDLETTE,
CHARLES O. SPEAR, Jr.,
ALLEN P. PAYSON,
Committee.

A true copy attest.

CHARLES W. BOWKER,
Secretary and Treasurer.

RESOLUTION OF ELYRIA FIRE FIGHTERS ASSOCIATION, LOCAL 474, ELYRIA, OHIO, NOVEMBER 12, 1938

Whereas the right of the Federal Government to impose taxes on State, county, and municipal employees, and also to tax States and municipalities on their own revenue receipts, was held by Supreme Court decision of May 23, 1938; and

Whereas this decision is contrary to the principles of American Democracy and will further jeopardize the financial security of the States, counties, and municipalities; and

Whereas the retroactive measure as upheld in the decision would work an unfair hardship on the employees of the States, counties, and municipalities: It is therefore

Resolved, by the Elyria Fire Fighters Association, local 474, in meeting, That this association request Members of Congress at the 1939 session; to support legislation that will prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities; and to oppose legislation that will add to the cost of State, county, and municipal governments by Federal taxation.

Unanimously adopted, November 10, 1938.

Respectfully yours,

C. C. OSBORN,
Secretary.

Resolution Adopted by the American Federation of State, County, and Municipal Employees[1]

Whereas the Federal Department of Justice and Treasury Department have contended "That the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated and supreme, taxing power of the central government"; and

Whereas as a result employees of the States, counties, and municipalities are threatened with an immediate retroactive liability for Federal income tax on their salaries earned for every year back to 1926; and

Whereas as a further result there is drawn into question the immunity from Federal corporate income tax of the revenues derived by the States, their subdivisions and agencies, taxation of which would derogate State sovereignty and add a crushing burden to the already heavy cost of State and municipal government; and

Whereas the Federal taxing officials have also asserted a constitutional right to add to the cost of State and municipal government by taxing State and municipal bonds while denying to States and their agencies a constitutional guaranty of their right to reduce that added cost by reciprocal taxation of Federal securities: Now, therefore, be it

Resolved, by the American Federation of State, County, and Municipal Employees in convention assembled this 31st day of August, 1938:

First. That the federation urges all members of and candidates for Congress and the Senate to support the following bill in Congress and the Senate to support the following bill in Congress at the 1939 session:

A BILL To prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That any taxes imposed by the Revenue Act of 1936 or prior Revenue Acts upon any individual in espect of amounts received by him as compensation for personal services as an officer or employee of any State or States or of any political subdivision, or any municipal or public corporate instrumentality or agency thereof (except to the extent that such compensation is paid out of the funds of the United States of America), together with any interest or penalties in connection therewith, shall be cancelled, abated, credited or refunded.

Second. That the federation opposes any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions and agencies; and

Third. That the federation cooperate with the Conference on State Defense, in furthering the above program, and that the executive committee is hereby given full power and authority to take all steps necessary in connection therewith; and

Fourth. That the secretary send a copy of this resolution to every affiliated local organization, together with the federation's recommendations that a similar resolution be adopted by each, that each local resolution adopted be sent to all members of or candidates for Congress and the Senate from that State and that each local organization actively support and work to secure congressional senatorial commitments for the program endorsed herein.

Adopted.

A. F. S. C. & M. E. Convention.

Atlanta, Ga., *August 31, 1938.*

[1] Resolutions identical in form or effect were adopted and submitted by the following locals of that organization: Buffalo, N. Y., Local 103, chs. 1, 2, 3, 4, 6, 7, 8, 9, 10, and 11; Manitowoc, Wis., Local 170; Aurora, Ill., City Employees Local 160; California State Employees, Local 14; Local No 59; St. Louis County Employees, Local 66-2; Two Rivers, Wis., Local 76, and Tuscarawas County, New Philadelphia, Ohio, Local 195.

The following organizations also adopted identical resolutions: The Federation of Public Service Employees, St. Paul Minn.; State Council of New Jersey Civil Service Association; Connecticut State Employees Local No. 16; Detroit, Mich.; Municipal Employees Club, Inc., and Pasadena, Calif., Municipal Employees Association.

The following organizations adopted resolutions protesting the imposition of a retroactive tax on the salaries of State and municipal employees: Municipal Employees Union, Local 626, Cedar Rapids, Iowa; Iowa State Municipal Employees Association, Unit No. 3 (Cedar Rapids), Unit No. 2 (Council Bluffs), California Federation of Civil Service Associations in Los Angeles and San Francisco Municipal Civil Service Association.

Resolution of Civil Service Forum

Whereas the Civil Service Forum, at its last regular meeting held on May 25, 1938, adopted a resolution protesting against retroactive taxation of civil-service employees' salaries by the Federal Government; and

Whereas our attention has been called to the proposed plan of the Federal Government to tax State and municipal bonds by means of passing legislation in the next session of Congress; and

Whereas the taxing of bonds and securities of the city or State of New York will seriously impair the credit of such city and State; and

Whereas any attempt to tax retroactively the salaries of civil-service employees would be both vicious and unfair and cause untold hardship to thousands of civil-service employees: Therefore, be it

Resolved, That the Civil Service Forum hereby approve and endorse the program and objectives of the Conference on State Defense to oppose the proposed plan of the Federal Government to tax the bonds and securities of the State and local governmental agencies, and the incomes of their employees, without the consent of the States being first obtained through the regular order of constitutional amendment; and, be it further

Resolved, That a certified copy of this resolution be forwarded to the Senators and Congressmen representing the State of New York, to the Civil Service Association of the State of New York, to the Attorney General of the State of New York, to the Attorney General of the United States, to the chairman of the Senate Finance Committee, and to the chairman of the House Ways and Means Committee.

Resolution of Los Angeles County Employees' Association

Whereas a certain study entitled "Taxation of Government Bondholders and Employees—the Immunity Rule and Sixteenth Amendment," forwarded by the Department of Justice to the Treasury Department on June 24, 1938, asserts a supreme power in the Central Government to tax the States without their consent, while denying reciprocal power in the States to tax the Federal Government; and

Whereas the Department of Justice has also asserted that revenues of the States are subject to the Federal corporate income-tax levies; and

Whereas the Treasury Department has declared its intention to use its power to collect 12 years' back taxes from employees of the States and the several subdivisions thereof as a bargaining weapon in connection with legislation removing future tax exemptions; and

Whereas it is the sense of this association that such a Federal attack would place the States in the status of counties or provinces of a central government and would in effect destroy the form of State and local government, and of the dual sovereignty under which the people of the United States have lived and prospered for over a century and a half: Now, therefore, be it

Resolved, by the Board of Directors of the Los Angeles County Employees' Association, representing 15,000 employees of the county of Los Angeles, Calif., and of the flood-control and other districts thereof, That we hereby endorse the program and objectives of the conference on State defense, denying the constitutionality of any attempt by the Federal Government to tax the revenues of the States, their political subdivisions, or employees thereof, without the consent of the States first obtained through proper constitutional process; and, be it further

Resolved, That we are unalterably opposed to the stated threat of the Treasury Department of the Federal Government to collect 12 years' back taxes from employees of the several States and their political subdivisions as a bargaining weapon in connection with future legislation; and be it further

Resolved, That the secretary of this association be directed to forward a copy of this resolution to the chairman of the Conference on State Defense, to the Board of Supervisors of Los Angeles County, and to the Attorney General of the State of California.

Adopted by the unanimous vote of the board of directors of the Los Angeles County Employees' Association, August 9, 1938.

Harry M. Hunt, *President.*
Matt N. Simon, *Secretary.*

OAKLAND MUNICIPAL CIVIL SERVICE ASSOCIATION,
Oakland, Calif., October 21, 1938.

A. J. TOBIN,
Secretary, Conference on State Defense.

Dear Sir: At the last regular meeting of the Oakland Municipal Civil Service Association the following resolution was passed:

Be it resolved by the Oakland Municipal Civil Service Association, That this association go on record as being opposed to the retroactive collection of income taxes from public employees by the Federal Government and also to future collection of income taxes from the public employees of the State, municipalities, and other State agencies. Be it further

Resolved, That copies of this resolution be sent to the honorable Senators and Representatives of the State of California.

Sincerely yours,

ED. RUSSELL,
Secretary-Treasurer.

RESOLUTION OF NEW YORK STATE ASSOCIATION OF ENGINEERS

Whereas the possible effects of current Treasury Department interpretations of recent Supreme Court decisions gravely concern engineers employed by the municipalities by—

(*a*) Threatening retroactive taxation of salaries they have received during the past 12 years and which they have assumed to be exempt as a result of previous Supreme Court decisions;

(*b*) By threatening to increase the cost of carrying on municipal government by removing the exemption which municipal revenues and securities have traditionally enjoyed, and that without the consent of the States through constitutional amendment; be it

Resolved by the New York State Association of Municipal Engineers:

First. That the association urge all members of and candidates for both Houses of Congress to support the following bill in Congress at the 1939 session:

A BILL To prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That any taxes imposed by the Revenue Act of 1936 or prior Revenue Acts upon any individual in respect of amounts received by him as compensation for personal services as an officer or employee of any State or States or of any political subdivision, or any municipal or public corporate instrumentality or agency thereof (except to the extent that such compensation is paid out of funds of the United States of America), together with any interest or penalties in connection therewith, shall be cancelled, abated, credited, or refunded.

Second. That this association invites the cooperation of each of the Congressmen and Senators which represent its membership in the Congress of the United States to defeat any proposal to impose Federal taxes on State and municipal securities and revenues without the States' consent, and to oppose any program which would increase Federal revenues at the sacrifice of equally necessary municipal government and the type of governmental services which can be performed only by the States and municipalities.

Third. That a copy of this resolution be sent to every Congressman and Senator in the State of New York, with an invitation for his support and a declaration of his position.

RESOLUTION OF THE PENNSYLVANIA CHIEFS OF POLICE ASSOCIATION, DECEMBER 28, 1938

Whereas the Federal Department of Justice and the Treasury Department have contended "that the principle of immunity protected the Federal Government against taxation by the States, but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the central government;" and

Whereas, as a result, police employed by the States, counties, and municipalities and their agencies are threatened with an immediate retroactive liability for Federal income tax on their salaries for every year back to 1926; and

Whereas, as a further result, there is drawn into question the immunity from Federal corporate income tax of the revenues derived by the States, their subdivisions and agencies, taxation of which would derogate State sovereignty and add a crushing burden to the already heavy cost of State and municipal government; and

Whereas the Federal taxing officials have also asserted a constitutional right to add to the cost of State and municipal government by taxing State and municipal bonds while denying the States and their agencies a constitutional guranty of their right to reduce that added cost by reciprocal taxation of Federal securities: Now, therefore, be it

Resolved, By the Pennsylvania Chiefs of Police Association, in meeting assembled this 28th day of December 1938:

First. That the association urge all members of both Houses of Congress to support the following bill in Congress at the 1939 session:

A BILL To prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities

Be it enacted by the Senate and House of Representatives of the United States in Congress assembled, That any taxes imposed by the Revenue Act of 1936 or prior Revenue Acts upon any individual in respect of amounts received by him as compensation for personal services as an officer or employee of any State or States or of any political subdivision, or any municipal or public corporate instrumentality or agency thereof (except to the extent that such compensation is paid out of the funds of the United States of America), together with any interest or penalties in connection therewith, shall be canceled, abated, credited, or refunded.

Second. That the association oppose any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the State through a constitutional amendment guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already-issued securities of the States, their subdivisions, and agencies.

Third. That the association cooperate with the conference on State defense in furthering the above program and that the executive committee is hereby given full power and authority to take all steps necessary in connection therewith; and

Fourth. That the Secretary send a copy of this resolution to every affiliated local organization, together with the association's recommendations that a similar resolution be adopted by each, that each local resolution adopted be sent to all Members of or candidates for both Houses of Congress from that State and that each local organization actively support and work to secure congressional and senatorial committments for the program endorsed.

Unanimously adopted December 28, 1938.

GEORGE BAUSEIRNE,
President.

D. T. MCKELVEY,
Chairman Executive Committee.

T. B. TITUS,
Secretary.

RESOLUTION OF THE NEW JERSEY STATE PATROLMEN'S BENEVOLENT ASSOCIATION

ATLANTIC CITY, N. J., *September 12, 1938.*

Be it resolved, That the New Jersey State Patrolmen's Benevolent Association record itself as strongly opposed to the attempt to impose a Federal income tax on the salaries of municipal officers and employees. The salaries of the great majority of such officers and employees are low and such officers and employees are not in a position to bear the burden of such an income tax.

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[1] An identical resolution was adopted and submitted by the California Association of Highway Patrolmen. Resolutions opposing the imposition of a retroactive tax upon salaries of State and municipal employees were adopted by the following: International Association of Chiefs of Police; Wisconsin Chiefs of Police Association; Rhode Island Chiefs of Police Association; New York Police Chiefs Association; Patrolmen's Benevolent Association of New York City; New Jersey State Patrolmen's Benevolent Association; Nebraska Policemen's Association; Missouri Crime Prevention Bureau; Fraternal Order of Police; State Police Association of Connecticut; Florida Peace Officers' Association, and Massachusetts Chiefs of Police Association.

Resolution of Troop G, New York State Police

Whereas it has come to the attention of the undersigned, members of troop G, New York State police, that a recent decision of the Supreme Court of the United States has been so interpreted by the Treasury Department of the Government that they have indicated their intention of collecting 12 years retroactive tax on every year's salary earned back to 1926 of all State, County, and municipal employees; and

Whereas the undersigned believe that it is incumbent upon the next Congress to define the policy which the Treasury Department should apply with respect to the subject, and it is the belief of the undersigned that Congress should enact legislation which would eliminate the retroactive effect of this decision; and

Whereas the undersigned, together with an overwhelming majority of all city, county, and State employees, have budgeted their yearly needs for their homes and families without allowance being made for the taxation of their salaries earned in each of the past 12 years, basing said action upon the accepted law that all public employees were constitutionally exempt from Federal taxation; and

Whereas the collection of this retroactive tax would be such a crushing burden as to be well-nigh ruinous to almost every State, county, and municipal officer and employee; and

Whereas it is the understanding of the undersigned that the interpretation by the Treasury Department of the decision previously mentioned would no longer guarantee the constitutional immunity of outstanding State and municipal securities from Federal taxation, which securities are largely held in the Treasury of the Pension Retirement System of the State of New York, and that the value and stability of such fund has depended in large measure upon their continued exemption from Federal taxation, and that such taxation would without question jeopardize the public pension fund: Now, therefore, be it

Resolved, That the undersigned, members of troop G, New York State police, favor a definition by the Congress eliminating the retroactive effect of the decision of the Supreme Court, made on May 23, 1938, in the case of *Helvering* v. *Gerhardt*, on the ground that its effect would be ruinous and disastrous to the great majority of State employees; and be it further

Resolved, That the undersigned desire to go on record as against the taxation of outstanding State and municipal securities by the Federal Government on the ground that such action would jeopardize the value and stability of the funds held by the pension retirement system; and be it further

Resolved, That copies of this resolution be forwarded to the United States Senators from New York and the Congressmen representing the various districts in which the undersigned reside.

Capt. J. M. Keeley
Inspector E. O. Hageman
Lt. M. E. Doescher
Lt. W. M. Green
Lt. H. A. Keator
Lt. G. A. Sager
Sgt. J. W. Wheeler
Sgt. A. M. Stanwix
Sgt. E. P. Conway
Sgt. Ralph Fitch
Sgt. P. J. Fitzpatrick
Sgt. W. H. Fluebacher
Sgt. F. L. Hutton
Sgt. G. R. Kerr
Sgt. D. A. Lawrence
Sgt. F. J. McDowell
Sgt. J. J. McNamee
Sgt. Henry Rasmussen
Sgt. James Rose
Sgt. J. W. Russell
Sgt. F. J. Schoonmaker
Sgt. G. R. Smith
Sgt. E. C. Updike
Sgt. F. L. Zeh
Corp. W. K. Cruden
Corp. J. C. Dwyer
Corp. L. G. Egelston
Corp. T. R. Ford
Corp. K. E. Gray
Corp. F. W. Hilfrank
Corp. G. F. Hurley
Corp. E. F. Merkle
Corp. J. R. Morris
Corp. J. R. Reynolds
Corp. H. R. Snyder
Corp. J. J. Luts
Corp. A. C. Rasmussen
Trooper W. J. Anslow
Trooper W. H. Barfoot
Trooper A. H. Barney
Trooper J. H. Barr
Trooper George Bihn
Trooper E. M. Blackmer
Trooper E. J. Blaney
Trooper J. J. Buckley
Trooper S. L. Bulson
Trooper H. J. Burmester
Trooper H. E. Chatterton
Trooper L. H. Closson
Trooper A. H. Clough
Trooper G. J. Clow
Trooper G. W. Craig
Trooper T. A. Curley
Trooper Arthur DeSormeau

Trooper R. F. Dingman
Trooper H. C. Doxsee
Trooper E. E. Doxsee
Trooper John Everhardt
Trooper G. A. Faircloth
Trooper J. E. Falle
Trooper J. F. Finn, Jr.
Trooper F. B. Fitzgerald
Trooper J. G. Flubacher
Trooper E. V. Foster
Trooper K. A. French
Trooper E. M. Galvin
Trooper T. J. Gilmore
Trooper R. A. Hamilton
Trooper E. D. Hanchett
Trooper E. T. Hanchett
Trooper H. E. Hart
Trooper J. R. Hock
Trooper E. J. Holohean
Trooper R. H. Jecklin
Trooper J. R. Johnson
Trooper J. F. Keating
Trooper F. C. Knight
Trooper M. S. Kniskern
Trooper C. J. Konior
Trooper F. P. Larsen
Trooper D. F. Lang
Trooper M. T. Legg, Jr.
Trooper J. F. Lettus
Trooper J. J. Lockman
Trooper C. O. McCreedy
Trooper G. N. McCreedy
Trooper F. J. McCullen
Trooper W. A. McDonough
Trooper J. J. Micklas
Trooper E. F. Minehan
Trooper J. V. Minnicki
Trooper J. B. Millman
Trooper R. J. Mohr
Trooper J. J. Murphy
Trooper M. H. Murray
Trooper H. F. Myers
Trooper W. A. Nennstiel
Trooper J. P. Olszewski
Trooper G. B. Reynolds
Trooper H. L. Rice
Trooper F. R. Russell
Trooper F. J. Sayers
Trooper L. E. Schermerhorn
Trooper H. A. Scoville
Trooper F. M. Shaxgy
Trooper C. E. Sheer
Trooper J. S. Sikora
Trooper J. H. Smith
Trooper F. J. Stark
Trooper J. J. Stewart
Trooper J. J. Sullivan
Trooper W. J. Sullivan
Trooper E. B. Terwilliger
Trooper R. M. Travis
Trooper L. J. Van Alstine
Trooper Carl Wichman

The original of this resolution with signatures of the individuals above mentioned is on file at the headquarters of troop G New York State police, Troy, N. Y.

J. M. KEELEY, *Captain, Troop G.*

RESOLUTION OF BUFFALO TEACHERS UNION OF THE AMERICAN FEDERATION OF TEACHERS, LOCAL NO. 377, BUFFALO, N. Y.

Whereas the Federal Department of Justice and Treasury Department have contended, "That the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the central government" and,

Whereas, as a result, every State, county, and municipal employee, including teachers, is faced with the immediate possibility of having to pay retroactive taxes on salaries earned in each of the years since 1926; and,

Whereas if the principle of immunity is lost by the States, counties, and municipalities, they will be faced with the crushing burden of raising additional revenue; and,

Whereas the contention of the Federal Department of Justice and Treasury jeopardizes the pension funds of teachers and other civil servants by permitting taxation of public securities in which a good part of these pension funds are invested: Now, therefore, be it

Resolved, By the Buffalo Teachers Union, Local No. 377, affiliated with the American Federation of Teachers, American Federation of Labor, in meeting assembled this 14th day of December 1938:

First. That the union urges all Members of the House of Representatives and the Senate to support the following bill in the 1939 session of Congress:

A BILL To prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That any taxes imposed by the Revenue Act of 1936 or prior revenue acts upon any individual in respect of amounts received by

him as compensation for personal services as an officer or employee of any State or States or of any political subdivision, or any municipal or public corporate instrumentality or agency thereof (except to the extent that such compensation is paid out of the funds of the United States of America), together with any interest or penalties in connection therewith, shall be canceled, abated, credited, or refunded.

Second. That the union opposes any taxation which will jeopardize the pension funds of civil service or educational employees.

Third. That the union opposes increased burdens on the States and municipalities through Federal taxation of State and municipal revenues and nonreciprocal taxation of State and municipal bonds.

Fourth. That copies of this resolution be sent to Senators Wagner and Mead, to the Representatives from the western New York area, to the Conference on State Defense, and to the local press.

RESOLUTION[1] OF THE COUNCIL OF THE ALLIED EDUCATIONAL GROUPS OF CUYAHOGA COUNTY, OHIO

Whereas the Federal Department of Justice and the Treasury Department have contended "that the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the Central Government"; and

Whereas as a result, employees of the States, counties, municipalities, and other subdivisions, are threatened with an immediate retroactive liability for Federal income tax on their salaries earned for every year back to 1926; and

Whereas as a further result there is drawn into question the immunity from Federal corporate income tax of the revenues derived by the States, their subdivisions and agencies, taxation of which would derogate State sovereignty and add a crushing burden to the already heavy cost of State and municipal government, and

Whereas the Federal taxing officials have also asserted a constitutional right to add to the cost of State and municipal government by taxing State and municipal bonds while denying to States and their agencies a constitutional guaranty of the right to reduce that added cost by reciprocal taxation of Federal securities, and

Whereas the taxation of outstanding State and municipal bonds would constitute a serious threat to the financial stability and successful operation of the Ohio State teachers' retirement system; now, therefore, be it

Resolved, by the Council of the Allied Educational groups of Cuyahoga County, Ohio, in regular meeting assembled on the 29th day of September 1938:

First. That the council urges all Members of and candidates for the Congress of the United States to support a bill in the 1939 session to prevent the retroactive application of any Federal tax upon the employees of the States and their instrumentalities.

Second. That the council opposes any attempt to add to the cost of State and municipal government by Federal taxation without first securing the consent of the States through a constitutional amendment guaranteeing the reciprocal right to tax future issues of Federal securities in the State and prohibiting any Federal taxation of the revenues and already issued securities of the States, their subdivisions and agencies.

Third. That the council cooperate with the Conference on State Defense, and urge its affiliated organizations to take such action as, in their judgment, will aid in furthering this program.

Fourth. That the secretary be authorized to communicate the terms of this resolution to members and candidates of both Houses of the Federal Congress and to such other persons and authorities as will in his judgment aid in furthering the purpose of this resolution.

A true copy.

IRA D. LUCAL, *Secretary.*

The CHAIRMAN. Mr. Lindsay.

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[1] Identical resolutions were adopted and submitted by: Legislative committee, New England Association of Colleges and Secondary Schools; West Virginia State Education Association. Resolutions opposing the imposition of retroactive taxation on salaries of State and municipal employees were adopted by: Wisconsin Education Association; Illinois Education Association; National Association of State Universities, and Louisiana Teachers' Association.

STATEMENT OF JOHN R. LINDSAY, DIRECTOR OF FINANCE, LOUISVILLE, KY., AND ALSO REPRESENTING 186 CITIES IN THE KENTUCKY MUNICIPAL LEAGUE

Mr. LINDSAY. Gentlemen of the committee: Having been engaged in the investment business for a period of 15 years prior to June 1934, and having specialized during that period in tax-free securities, I fully appreciate the problems involved in taxation of municipal bonds. There are, at the present time, something in excess of $65,000,000,000 of tax-free securities in the country, and if these securities are made subject to Federal income tax, the annual income to the Federal Government will be something in excess of $300,000,000. Unless taxation be made retroactive, this income would not be realized at once, but would accrue over a period of years as new securities were issued. The essential thing to bear in mind is the eventual source of revenue and by this means to determine the sound economy of such a tax program.

Inasmuch as State and local government securities comprise the largest single group of tax-exempt issues, it might be well to consider this group separately. During the past 10 years, financial administration of local government has undergone many revolutionary changes whereby, with hardly any exceptions among the larger cities, financial administration is such that waste and inefficiency has been reduced to a minimum. In the case of my own community, an inland city 350,000 population, we have managed to weather the storm of the past 10 years' depression without recourse to borrowings, and with a continued balanced operating budget. We have been able to carry our relief burden out of current revenues, and have not added new sources of revenue. This is not an unusual situation, but one that exists in the majority of cities in the country. Louisville, like most other communities, is handicapped by a constitutional tax limit, and we now find ourselves facing serious financial difficulties in the event of additional expenditures.

It has been conservatively estimated that subjection of municipal bonds to Federal taxes would result in increased interest requirements ranging from one-quarter of 1 percent to three-quarters of 1 percent. Long-term noncallable city of Louisville bonds recently sold in the open market to yield 2.15 percent and short-term serial obligations at a proportionately higher price. These figures clearly reflect the high credit standing of Louisville obligations, but I am not so biased as to believe that our credit rating alone is responsible for such a demand on the part of investors. The wholly tax-free provision of municipal obligations is responsible for at least one-half of 1 percent in this basis price.

Louisville, being located on the Ohio River, is rapidly approaching the time when flood control and river pollution must be acted upon and not talked about. The solution of these two problems will mean an expenditure by the city of approximately $20,000,000. An increase in interest rates of one-half of 1 percent would mean something over $100,000 a year over a period of 30 or 40 years for the city of Louisville. The city's gross indebtedness, at the present time, is approximately $42,000,000 and an increase of one-half percent in interest charges on this indebtedness would amount to approximately $200,000 a year. As compared to national figures these figures seem insignificant, but

proportionately they are of serious size. For Louisville to have to pay one-half of 1 percent additional interest charges on future bond issues, and to have to pay income tax on State and municipal bonds held in sinking funds would mean that one or more of the essential activities of the city government would have to be seriously curtailed or eliminated.

The general operating revenues are the only sources from which additional expenditures of this character might be met. Such additions will directly increase real-estate taxes at a time when every effort is being made to lighten them. Real estate in Louisville is now carrying approximately 83 percent of local taxation and is ill-equipped to stand any additional burden. The average homeowner in Louisville with real estate valued at $5,000 pays an annual city tax of $120. The majority of individual taxpayers fall in this classification, and any additional charges will, therefore, affect those persons who at the present time are carrying the greatest tax burden in proportion to income and that group least able to stand additional taxation.

In summary, I take the position that the largest portion of anticipated Federal revenue from taxation of municipal bonds will fall first on the group of individuals most heavily taxed in proportion to income, and least able to stand additional taxation, and on the municipalities themselves who, hardly without exception, are sorely pressed to meet the necessary functions of government. This additional burden on the cities will result, in a great many instances, in serious impairment of credit and curtailment or discontinuance of essential governmental activities.

The CHAIRMAN. Mr. Armstrong.

STATEMENT OF C. E. ARMSTRONG, COMPTROLLER AND DIRECTOR OF FINANCE OF THE CITY OF BIRMINGHAM, ALA., AND ALSO REPRESENTING THE ALABAMA LEAGUE OF MUNICIPALITIES, CONSISTING OF 104 MEMBER CITIES

Mr. ARMSTRONG. Gentlemen, we appreciate this opportunity of appearing here and discussing with this committee this problem, which we think is of such grave importance.

We are appearing before you today after some 25 years of experience in municipal government, the greater part of which time I have served as city comptroller and director of finance of the city of Birmingham.

During these same years, or nearly all of them, I have been an active member of the Municipal Finance Officers' Association of the United States and Canada, and, for a number of years, have served as one of its officials, and was president of this association in 1934.

I am a member of the Alabama League of Municipalities.

I have taken an active interest in this work, representing more than 100 cities, and I am delegated to represent them here today.

I simply cite this fact in order that you may understand that at least I have had the opportunity of finding out whether or not I know something about the problem of local government and municipal government.

Now, yesterday and today there has appeared before you a large group of men, the majority of whom are active public officials. I am sure you must be impressed with the fact that they are gravely alarmed

at what this proposed legislation might do as regards their respective operations.

You have heard from the North, you have heard from the East, you have heard from the West, and now, if you please, gentlemen, you are going to hear from the poor people of the South. I say that designedly, because the claim has been made that the purpose of this legislation is to, in a sense, get the rich.

I think that, inasmuch as the richer communities of the United States are concerned, and I know they are gravely concerned, we, in the poorer sections of our country, are more concerned.

You know, down south, talking about being poor, when you cannot think of anything worse to call us, you call us the national economic problem No. 1. That has some significance in connection with this matter, and among many of us, in viewing the situation, sometimes we think that maybe you may be developing economic problem No. 2. God save us from the second until we get rid of the first.

Now, in this discussion today—it shall be largely general, and I shall not burden you with a large number of statistics, inasmuch as you have heard a large number of statistics as a necessary background, and I shall not burden you with them again—I wish to say that there are two questions involved, major questions. The first one is: Can it be legally done, and, if so, by what process?

That is a question for our lawyers to argue and our courts to decide.

If the proposed taxation is legal, or if it can be made so, it is sufficient to say that if and when the Federal Government does finally tax the local governments and their instrumentalities, it matters little whether it be done by statutory provision or through the constitutional amendatory process.

It does appear to me, however, regardless of whether or not this Congress now has or may be given authority to levy this tax, that technical legal right as between the Nation and the States in matters as important as this, the final prerogative of local governments, should be exerted only as a means of last resort.

The second question, and the one that I think is the more important of the two, is the effect that such taxation might have on local government prerogatives, in violation of the long-standing American tradition of dual sovereignties in government, and if this tax is levied, would it promote the interest of the majority of our citizens living under this multiple system of government that is ours?

I shall make no mention of retroactive taxation. I think, largely, that is out of the window.

Senator LOGAN. That is right.

Mr. ARMSTRONG. Then, that brings us to the question of taxing bonds issued in the future.

The taxing of salaries, possibly the committee is not concerned with now. I would like, briefly, to make one or two statements regarding the taxation of salaries after I clarify my position in connection with the other matters. I do not see that there is any difference in the principle violated in the taxing of salaries different from what is violated in the taxing of income.

But, in this case, I am more interested in what will be the possible effect and what will be the practical effect of this taxation.

Unless it can be shown that the local government salary schedules are made with the idea that there is to be tax immunity, then I would

say to you frankly that there would be no justification for continued immunity from the taxation of salaries. My observation and experience is that local governmental salary schedules are certainly not formulated with any idea of tax immunity. I do not believe that in a great many cases the taxing of salaries would increase the cost of local government, and therefore, personally, I do not object to the taxing of salaries, and I have long made that statement, long before the issue came up.

But, when it comes to taxing income, it is almost an irrefutable fact, and admitted by the proponents of this measure, that it will increase the cost of local government, and in that I am vitally concerned.

It seems that most of the argument for this tax is based on the theory that a certain part of our people are escaping their just share of the cost of government. That may be so. If so, it is certainly a terrible condition, and should be remedied, if possible, but not necessarily at the expense of the majority of our people.

The question is, Will this legislation effect that correction? Will it soak the rich, as we have been given to believe by the proponents of the measure?

The next question that arises is, Will this tax affect the interest rate that new securities will bear? Practically all agree that it will. The difference is in the amount that it might affect them. The proponents say, in the highest type of securities, that it will range from zero, or nearly that, to a quarter or perhaps one-half of 1 percent. That is perhaps more of a theoretical viewpoint of the proponents, rather than one based on actual daily experience.

On the other hand, you have the dealers' experience, saying that the minimum rate on the highest grade, in their judgment, will be three-fifths of 1 percent, and saying that it will possibly go up on the low grade to as much as 1 percent or more.

There, again, you will see that it is the poor being soaked, and again being made the goat, and they are going to have to bear the greater part of the burden. It is the poor sections of the country that are going to be soaked, not only the South, but we have some in the Middle West, and the iron hand will be dropped heavily on some of the other sections of the country.

I could quote you here, and I have a brief that I want to leave with you, and I am not following that closely, but the proponents themselves are admitting in several instances that the interest rate on the bonds will be increased, or, what amounts to the same thing, that they will be purchased at sufficient discount to absorb this tax.

After all the buyers in the market largely fix the price, if they know in advance, and it is my experience from observation and general judgment that, if one has got to pay a tax on the investment, it certainly will, in my judgment, be reflected in the bid that he makes on the bonds.

You know, gentlemen, after all, it occurs to me that this is simply a further Federal invasion of the local tax field. They have already gone a good way in that direction. They have been all preempted. When considering this proposition of one government taxing another government, or, rather, making a collection agency out of the lower strata of government, really, it occurs to some of us that that is going to be difficult to justify.

We know it is sometimes difficult to justify our method of taxing individuals, but, when it comes to one government taxing another government, some of us think it is about time to stop, look, and listen.

The CHAIRMAN. Do you know that we have many persons here in Congress who believe that the Federal Government should be required to pay a tax upon the large amount of lands and properties owned by the Federal Government, forest lands in the various States? In my own State of Michigan all of the State-owned lands, which we call swamp lands, the State pays 10 cents an acre to the local government. So that it works both ways.

Mr. ARMSTRONG. I hope to touch on that more when we get to the reciprocal feature of this bill.

The CHAIRMAN. I know that Senator Schwartz and some of the other Senators have a bill to that effect.

Senator LOGAN. May I ask a question, Mr. Armstrong?

Mr. ARMSTRONG. Certainly, Senator.

Senator LOGAN. There is a strong trend that the Federal Government do something to adjust the amount of revenue that the States and counties lose. Personally I am in favor of making some adjustment.

Mr. ARMSTRONG. May I ask, even though they were to pay 10 or 12 or 15 cents per acre, would that be comparable to the privately owned lands?

The CHAIRMAN. No, it would not be.

Mr. ARMSTRONG. As to the amount of revenue that might be produced, it has been variously estimated. You have that in the record.

Mr. Magill said that in 1937 the increased Federal revenue from State and local government securities—and it is admitted that most all of this will have to come from the municipalities—will be, probably, $70,000,000 annually. That will be more in due course of time.

Dr. Lutz, who has made an exhaustive study and analysis, says that it possibly will be $113,000,000, and if we want to take an average we would have about $90,000,000 coming from State and local governments.

I am gravely concerned, like so many people are, about the principle involved.

Suppose the Federal Government does get $90,000,000 from the local governments, off of the people back home, which will come through real-estate taxes and license taxes and everything else—$90,000,000 a year—that is a lot of money to a municipality. Municipalities have such limited taxing authorities as compared to the Federal Government.

As you gentlemen well know, it is approximately 1 percent of the expenditures last year.

Senator LOGAN. Let me say, Mr. Armstrong, so far as this legislation is concerned, in my humble opinion, that it cannot be justified on the amount of revenue that the Federal Government will receive, or the States will receive. I am in full accord with what you say about the amount of revenue. I think that is inconsequential.

Mr. ARMSTRONG. All right. May I say, being specific, in the case of my own city, with some $26,000,000, today, gross, and estimating the increase because of this tax in the days to come, it might be as little as one-half of 1 percent—and I regret to say that our bonds are classed as low-grade bonds for various and sundry reasons—but that

would mean, on the basis of one-half of 1 percent, some $130,000 or $140,000 a year, and more likely three-quarters, or some $200,000 a year.

Senator LOGAN. Have you got those figures accurately? $26,000,000; 1 percent of $26,000,000 would not amount to $100,000—I mean, one-half of 1 percent.

Mr. ARMSTRONG. Yes, sir; one-half of 1 percent on $26,000,000 indebtedness would be $130,000.

Senator LOGAN. Perhaps that is right.

Mr. ARMSTRONG. And in my State there is $205,000,000 outstanding.

The CHAIRMAN. You mean State and municipal?

Mr. ARMSTRONG. There are $205,000,000, State, county, and city, and more than two-thirds are local bonds.

Senator MILLER. What is the rate on local bonds?

Mr. ARMSTRONG. Our bonds are selling on a basis of about 3½, compared to the rate of 2½ in the more favored sections of the country.

I believe, Senator Miller, you are from Arkansas. Over there, you are familiar with the rates that are charged on bonds?

Senator MILLER. We start at 10 percent, and go on up or down, whatever is necessary.

Mr. ARMSTRONG. Gentlemen, with the possible exception of the State of Georgia, the entire South, as a rule, are paying already an exorbitant interest rate, and their securities are frequently classed as second class bonds.

The popular belief in this type of bond will be destroyed because of the increased rate which will be proportionately more, and the fact is true that you are soaking the poor and probably not catching the rich at all.

Now, as I see it, the rich man must still be simply the medium through which the tax is collected. I do not believe that it will materially change his status, and neither do I believe that it will produce private capital in our industries, which effect they say it will have, until this Government of ours develops a more stabilized tax, until there can be worked out a more harmonious understanding between the Federal Government and industry. Until that is done, I believe, in my humble opinion, even with this tax, that they will continue to invest in these governmental securities.

Take, for instance, back in the roaring twenties, when everybody thought they were rich, and even the Government: There was no dearth of investment capital. There was investment for all of the municipalities' securities outstanding that were issued in that period.

On the other hand, industry expanded as never before, and probably to a greater extent there was an increase in municipal bonds, and there was capital for both.

Therefore, I do not believe that by putting any tax on it, it will drive these bonds into the industrial light.

Senator LOGAN. Let me ask you a question. You speak of the issuance of these bonds in the 1920's. In your opinion, in effect are these bond issues unwise, and could the municipalities have gone along without them?

Mr. ARMSTRONG. Senator, I have always tried to be most conservative in my attitude towards bond issues. Frankly, I believe that the public trend, due to the social and economic changes, could not have

carried on their expenditures at very little less than what was done. The people wanted more. They wanted better health protection, and they wanted recreation in the way of purchase of parks and things of that kind. I do believe, and I have often said so, that sometimes the public insists upon having things that maybe they cannot afford, but I seriously doubt that that was true back at that time.

Senator LOGAN. If the public wants these things, there is no way to ever get it back than for them to do without them.

Mr. ARMSTRONG. You are quite right on that, Senator. That has been my experience through a long number of years. They are not willing to give up what they have.

Someone has suggested that this tax might curb local government expenditures, what you might call extravagance. I think that the proponents are probably claiming that.

It seems to me that they are in rather a peculiar position—they are not, apparently, as I see it, practicing much economy themselves; that, apparently, as we see it, they should practice a little economy themselves, and that they would then set an example first, and I believe that then they would be in a better position to talk about that.

Senator LOGAN. And the more bonds that are issued, the cheaper the interest rate is.

The CHAIRMAN. I do not think that Mr. Hanes advanced that argument in his statement. He was the Government's representative who came here to announce the position of the Treasury and the Administration.

But it has been argued by some of the proponents that—and I cannot leave that statement without calling attention to the fact, which everyone here knows—because of the great demand for Federal aid to municipalities and counties back home, to build schoolhouses and pave highways and streets. Because the limitations are established in the taxation of city, county, and State property, the only unlimited taxing power seems to be in the Federal Government, so everybody turns to the Federal Government.

Mr. ARMSTRONG. Yes; but they are closely related.

The CHAIRMAN. Yes; but the Federal Government seems to be taking care of a good many local affairs.

Mr. ARMSTRONG. I say this, I think that the distinctive trend of public opinion today is for the local government to get away from leaning so heavily on the Federal Government.

But we have this situation, lately, as to the relief program. Of course, the Federal Government came to the aid of the local government at a time when there was no one else to whom they could turn, and I think that they did nothing more than it was their duty and responsibility to do, but, today, the movement is turning to go back, and it is a well known fact that local governments have largely financed their matching of Federal funds through the issuance of long term securities for this or that or some other kind of improvement.

If this proposal goes through, it looks to me like it is going to make it that much more difficult for the local government to go on taking care of expenditures that have been added, and that they be turned back to them in the way of relief.

Senator LOGAN. There is one thing I do not distinctly understand. I understand that the bond sale of municipalities has been at a standstill, at what they were years ago, and that by reason of Federal

expenditures the municipalities have not been called on to issue new securities.

Mr. ARMSTRONG. I think that is true. The Federal Government has done something in that way, but, as the years come and go, the municipalities, when they get back on their own, have certainly to do a lot themselves in order to keep the thing going. Right in that connection we have the case of refunding bonds. I think on that point that no one has said that this proposal would make refunding bonds exempt, and I take it that refunding bonds would have to bear the tax.

There are one-fifth of the people in the United States today living in States that are afflicted, in some form or another, with constitutional tax limitations. My State is one.

Senator LOGAN. So is mine.

The CHAIRMAN. Do you consider that an affliction?

Mr. ARMSTRONG. I consider it an affliction from the standpoint of credit. It is almost impossible, today, to reform any constitutional limitation, even as to debt. The people are scared to death, and even though you might show to them that it is a savings in debt, they will not do it. Consequently, you have got to refund a number of these bonds, and, if this proposal goes through, we are caught in the state and we are in a helpless situation, and we are going to have to issue these bonds on this high rate of interest, and like it.

Senator LOGAN. I think that you are absolutely correct on that constitutional limitation feature. The city of Louisville is the best-governed city in the United States, but the city right now is up against a good deal of trouble, because they are up against this limitation, and the people will not be induced to remove this limitation.

The CHAIRMAN. I am interested in this refunding proposition. I call your attention to the fact that the House passed a bill in 1918 in which they exempted refunding bonds from the tax. That did not pass the Senate. Is there any practical way that you, as a city official, can see by which you could protect against the issuance of so-called refunding bonds that might be actually issued for other purposes?

Mr. ARMSTRONG. It seems to me, Mr. Chairman, that protection could be provided if, in your Federal measure, you could define what constitutes a refunding bond.

The CHAIRMAN. Do you think that that could be done?

Mr. ARMSTRONG. I have not given it any study, but I imagine you could do it.

The CHAIRMAN. I was wondering if the municipality could not possibly use its funds for some new purpose, and maintain and claim that the bonds that were actually used for some other purpose were in reality refunding bonds.

Mr. ARMSTRONG. I think that you will find that the State legislatures in most cases largely take care of that, in protecting these funds that should be applied to debt service.

The CHAIRMAN. You think that a practical statute could apply to refunding bonds?

Mr. ARMSTRONG. I would say, offhand, without giving it careful thought, that it could be done.

Senator LOGAN. I would like to ask you, Mr. Armstrong, one question. It was generally supposed, and I think it is still the view of some of our great lawyers, that the Federal constitutional amend-

ment providing for an income tax covered income from any source, and that it would cover the thing that we are talking about now.

If the Supreme Court should hold today that all of these bonds are subject to income tax, what would be the general result throughout the country?

Mr. ARMSTRONG. You mean the bonds that are already outstanding?

Senator LOGAN. Yes. You know the constitutional amendment uses the expression, "income from any source" is subject to tax, and suppose the Supreme Court should say that it means what it says, then, what would be the effect on the municipalities throughout the country?

Mr. ARMSTRONG. I think it would invoke an enormous amount of injustice. In general, I think that would be one of the greatest reflections on the Government that ever happened in this country. I believe this, I believe it would affect the sale, in any form, of local government bonds.

Senator LOGAN. What would happen to those already issued, where the city is up to its tax limit, and you had to increase, in your city $130,000 a year, and you could not get the money?

Mr. ARMSTRONG. With those bonds already out, the city would not have to pay the extra load, but it would catch any investor who bought them in good faith with the tax-free feature.

Senator LOGAN. That is true, but in refunding it would affect them?

Mr. ARMSTRONG. That is true.

Now, I have got one or two points further that I want to bring up. We have this paradoxical situation: Our Government has been spending hundreds of millions of dollars in the hydroelectric development. That is particularly true in the South and the Middle West, and they are encouraging, in that way, possible municipal ownership of public utilities, and, whether or not we can do it, and I am frank to say I do not think so except in those comparatively few utilities such as water.

If this proposition goes through, the Government, on the one hand, is making it more difficult for the cities to do the thing that they are asking us to do. In other words, it is a case of the left hand not knowing what the right hand is doing. It seems to me that it is coming right around in a cycle.

Now, this reciprocal situation, gentlemen, I want to speak on that for a moment. Reciprocity is all right when it reciprocates. But, as I see it, and as has already been pointed out very well, reciprocal privilege is an empty phrase. The most that we could get would be, probably, from 17 to 30 million dollars, and even that would go to the State, and almost nothing of it would filter down to the municipality, the government that is paying the big part of the Federal tax.

If they are really sincere in their reciprocity proposition——

The CHAIRMAN. I want to call to your attention, and to the attention of other people who are interested in your viewpoint, that I have not had any discussion so far of the Federal plan of taxation, of national bank stock. I see no reason why the Federal Government should not permit the same tax on its securities as the State permits in the taxation of its securities.

Now, if you are familiar with the national-bank law, you will recall that the Government permits the taxation of the stock of federally chartered national banks on the same basis as the State taxes State

bank stock, and, in my State, and I know, from my experience here, throughout the country, the taxation of national bank stock by States is similar in all respects to the taxation of State bank stock. As to local municipalities, I see no reason why the State could not authorize some form of such local taxation which would have to be assented to by the Federal Government. I do not think that we could throw the possibility of this taxation out of the window.

Mr. ARMSTRONG. I am not thoroughly familiar with that issue, but I know there is no little argument on that.

But I do know that from a reciprocal standpoint, which I am keenly interested in, if you are really sincere about that and truly want to help take care of this situation, then why not open up to the local tax jurisdictions the taxation of all of this field, and also the taxation of the very vast and fast increasing amount of Federal property, and, if you do that, gentlemen—and I am not suggesting that it be done, except that if this proposition is going through, and that we be given some relief—but, if you are going to remove all of those exemptions, it might very well go into that, as we all know these properties are increasing, and the rates on these properties are increasing.

Take, for instance, the low-cost housing problem: They are exempted from taxes, and they even make us put up so much money for recreation and such things as that, and the increasing number of Federal properties, as regards local taxes, that is really getting to be a serious problem.

The CHAIRMAN. This proposition would stop the issue of that sort of securities?

Mr. ARMSTRONG. Gentlemen, that pretty well covers what I have to say. I have a short brief here in which I have said a great many things that are not in my statement, and I want to leave it with you for your consideration.

You have given me a very considerate and sincere hearing, and I hope sincerely that you will remember, in this low level of city governments, that we have the least taxing power of any of the local governments, State, county, and city, and that we would have to pay most of this tax, and it is the cities, in which our people live and are most concerned, that serve your Government.

The CHAIRMAN. Thank you, Mr. Armstrong.

Mr. TOBIN. Mr. Armstrong has a very short and excellent brief, which I ask be printed in the record.

The CHAIRMAN. It will be received.

(The brief submitted by Mr. Armstrong is as follows:)

STATEMENT OF C. E. ARMSTRONG, COMPTROLLER AND DIRECTOR OF FINANCE OF CITY OF BIRMINGHAM, ALSO REPRESENTING THE ALABAMA LEAGUE OF MUNICIPALITIES, CONSISTING OF 104 MEMBER CITIES

In the proposal to tax Government securities at least two major questions are involved:

(1) Can it legally be done, and if so, by what process? This question is primarily one for lawyers to argue and our courts to decide. If the proposed taxation is legal or can be made so, it is sufficient to say that if, and when, the Federal Government does finally tax local governments and their instrumentalities, it matters little, whether it be done by statutory provision or through the constitutional amendatory process.

(2) Would such taxation be sound in principle and result in practical benefit to the greater number of people concerned in our multiple system of government?

This is more of a layman's question, and will be discussed here, largely with that viewpoint.

To the average American citizen, the question of whether or not Congress is, or can be legally empowered to lay and collect taxes on income derived from investments in local Government securities, is of secondary importance to the principle involved in so doing, and the effect such taxation might have on local government prerogatives. In any event, with our long-standing American tradition of dual sovereignty in Government, it is significantly important that technical legal rights as between the Nation and the State, should be asserted only as an urgently necessary and final resort.

RETROACTIVE TAXATION

No discussion of such taxation is here made, for the reason that it is now believed, that there is no consideration to be given to such action, except legislation that will clearly exempt Government salaries, etc., already earned.

TAXATION OF FUTURE SALARIES AND INCOME FROM NEW SECURITIES

Theoretically, there is no difference in the principle violated, in the taxing of future Government salaries paid by local governments, than in taxing of income from bonds issued by such local governments. The taxation of salaries, however, could and probably would, in many instances, if not in most cases, have a vastly different practical result, insofar as added cost of the local government was concerned.

It may be contended in part, and often with considerable merit, that such a tax on salaries, would not likely materially increase local government costs. Such a contention can be supported on the theory that salary schedules are frequently formulated without consideration of tax immunity.

Therefore, in the interest of fair play and equity in taxation, personally, I am not opposed to Federal taxation of future salaries paid by local governments—conditioned upon States being given an equal grant of authority to tax Federal salaries paid within their respective jurisdictions.

On the other hand, it is an almost irrefutable fact that the taxation of new securities would bring added interest costs, and thereby materially handicap and additionally burden local governments.

The proponents base their argument for elimination of the present immunity on the theory that so long as it exists, too many "rich people" will continue investing in nontaxables and thereby escape income taxes and not pay their just share of the cost of government.

Even though that might be true, will this tax proposal correct the evil? Will this system "soak the rich" as the Treasury Department would have us believe, or even put a brake on continued investments in nontaxables? On the other hand, won't the result be just the reverse, and be another case of "soaking the poor" in the way of increased real-estate and local license taxes that the "people back home" are already paying under strain? After all, wouldn't it be another instance of the "consumer paying the freight"—the consumer in this case being the local government and its tax-paying public?

In the investment field, the buyer largely creates or at least controls the market through his price-fixing methods. If this buyer knows in advance that the Government will demand additional taxes on income derived from certain investments, such taxes will be absorbed through a reduced price paid for the investment—or what amounts to the same thing—an increased interest cost that will be paid by the issuing authority rather than by the investor.

The investor will remain only the medium through whom the tax will be collected. There will be no escape for the local issuing authority and its tax-paying public.

Here is further thought as to who pays, and how much:

Mr. J. S. McCoy, Government actuary under Treasury Secretary Mellon in 1922:

"There is little doubt that under these conditions the future investor in what are now tax-exempt securities would demand that they have a higher rate of interest or be sold at a discount sufficient at least to meet the tax."

Mr. L. H. Parker, chief of staff of Joint Committee on Internal Revenue Taxation (1937):

"It is the opinion of this office that if the income tax was applied in full to all future issues of these bonds the increased interest cost would nearly offset the additional revenue secured."

Secretary Mellon of the United States Treasury, in giving testimony in a hearing on a proposed tax-exemption amendment in 1922, declared that a 3½-percent tax-exempt Government security then selling at par:

"Would have to pay a rate of more than 4 percent of course * * * somewhere from 4½ percent to perhaps 5 percent, depending on the length of time they would run."

Hon. John Nance Garner, Vice President of the United States, banker, and businessman of many years, speaking in the House of Representatives in 1922 against a proposed constitutional amendment to abolish tax-immune securities (Congressional Record, vol. 64, p. 712, 67th Cong.):

"The advocates of this amendment talk about it from an economic standpoint. I can demonstrate, and the estimator of the Treasury Department will bear me out, that for every dollar's worth of taxes you get in the way of taxation by virtue of this amendment, the interest paid will be four times that tax. The people pay this in the long run whether the bonds are issued by the Federal Government, State government, county * * * or by whatever other political subdivision. The people pay for it after all. Why do you want to adopt a system by which for every dollar you get into the Treasury of the United States, $4 will have to be paid by the public in the form of added interest?"

In the last analysis, Federal taxation as hereby proposed appears to be nothing short of a further invasion of the local tax field, under the guise that the "rich" will be forced to pay a tax they are now escaping, but which in the end, will not change the "rich man's" status.

Even for those of us in Government service, it is not always an easy matter to justify some of our plans and methods of taxing individuals, but when one government starts taxing another government (which in effect, local officials claim this proposal to be) it is high time for those who believe in the American system of government to stop, look, and listen.

Without intending to delve into controversial statistics, it seems to be pretty generally admitted—even by the proponents—that probably as few as 5 percent of the present immune securities are owned or controlled by taxpayers falling within the high-surtax brackets—those with net incomes of $50,000 or more per year. That, in itself, rather definitely refutes their claim that the "rich" are escaping their just share of Government cost, because of the present immunity.

ADDITIONAL INTEREST COST

Authorities differ greatly in their estimate of the added interest cost that may be expected to follow. Proponents of the bill—some of whom perhaps have more of a theoretical viewpoint, rather than one based on actual investment experience—claim that the differential between yields of completely taxable and wholly tax-exempt high-grade securities, varies from zero, or nearly zero, for the shortest maturities, to about one-fourth to one-half of 1 percent for the longest. Much contrary to the foregoing is the estimate of a conservative group of experienced dealers, to the effect that the approximate minimum increased average interest cost on high-class securities would be not much less than two-thirds of 1 percent, with an increasing amount up to 1½ percent or more on the lowest grades.

This increasing cost on the low-grade security is further evidence of "soaking the poor" this time—the "poor issuing authority" rather than the "rich issuing authority." This effect would be of especial significance to many southern municipalities, who oftentimes, because of conditions largely beyond local control, are already being forced to pay much more interest than is now necessary in more favored sections of the country.

Expressed in dollars of added Federal revenue and probable cost to local governments, are the following opinions.

The proponents say that in some 30 years or more—when all present immune bonds have been retired—the proposed tax on a similar amount to what is presently outstanding in the way of Federal, State, and local issues, will produce net (after allowing for reciprocal taxation) additional Federal revenues of $160,000,000 minimum to a possible $283,000,000. Using a medium, it would be $222,000,000 annually, or about 2½ percent of the total cost of Federal Government operation in 1938. The same authority estimates the maximum increased interest cost to State and local governments only, to be $105,000,000.

There is also the very interesting statement of Dr. Roswell Magill, Under Secretary of the Treasury in 1937, as follows:

"Although the exact data as to the distribution of State and local bonds by type of investors are not available the best information which we have available, leads us to estimate that if the Federal Government were authorized to collect

Federal income taxes upon the interest of State and local bonds now outstanding, the additional revenue at existing levels of income and under the provisions of the present revenue law would be approximately $70,000,000 annually."

This amount is but slightly more than three-fourths of 1 percent of the total Federal expenditure in 1938.

Dr. Harry Lutz, professor of public finance, Princeton University, after a very careful study and analysis, estimates that the proposed Federal taxation of State and local securities only, would cost the States and municipalities, a minimum of $113,000,000, with a possible revenue of $95,000,000 to the Federal Government, or a revenue of but slightly more than 1 percent of 1938 Federal expenditures.

Thus, at the most, the revenue as so estimated, would be of small significance to the Federal Government when compared to their total requirements. Nevertheless, it would be a matter of serious consequence to local governments—particularly municipalities who not infrequently are possessed of almost no taxing authority of their own, and who would have the majority of this additional burden to bear.

The question might well be asked, "Is the light worth the candle?"

In my city, it is conservatively estimated by investment dealers, that if our present outstanding bonds had been taxable at the time of their sale, our additional interest charge would be not less than $150,000 to $200,000 annually, an amount that would be of serious proportions under our limited taxing powers. It would certainly very materially increase our taxes on real estate. It is believed that our case is not materially different from that of hundreds of other municipalities throughout the country.

In this connection, it is well to remember that of the total nontaxables of approximately $65,000,000,000 now outstanding, about 70 percent of them, or $46,000,000,000 are Federals.

Local governments are not concerned as to whether or not the Federal Government taxes its own securities. It is to be noted that Federal authorities claim the increased rate of interest on local securities as a result of the tax will be "nearly zero" in some cases, to a maximum of one-half percent, whereas, other authorities believe the increase will range from approximately two-thirds to 1¼ percent or more. Therefore, it is respectfully suggested, that if the proposal is to be further prosecuted, that the tax for a period of at least 5 years, be limited to Federals—and thereby provide a test period in which to demonstrate either the correctness or fallacy of the Government's claim.

It is further submitted, that even though the proposed tax would result in twice the amount claimed, it would still be of small comparative consequence, in our Federal fiscal program as compared to what it would mean in the way of sacrificing our long-established principles of dual sovereignty in American Government.

HOW MIGHT IT AFFECT THE RELIEF PROBLEM

Already our cities are frequently strained almost to the breaking point, with their part of the relief load. Much of the cities matching of Federal funds for that purpose, is now being done through the issuance of long-term debt of one kind or another. Higher and more interest costs can mean but one thing, viz: Less local ability to issue bonds and thereby, less matching of Federal funds for relief. Under these conditions, we can reasonably expect as an ultimate result, a continuation of our present large scale of Federal relief spending, with a possible increase of as much in relief appropriations as the new tax would produce in additional Federal revenue. If the foregoing theory is correct, of what not advantage would it be to the Federal Government?

Popular opinion seems to be rather fast developing—and probably correctly so, that if our relief problem is ever to be anything like satisfactorily solved—there must be placed a greater local responsibility, financial and otherwise. If that is done, and this tax is imposed, we will have the paradoxical situation of the Federal Government shifting some of its financial burden to the local governments—and at the same time, making it more difficult, if not impossible, for local governments to finance the job. In that, we would have an illustration of "lightning striking twice in the same place."

Local governments must remain untrammelled by the Federal Government, if it is expected that they will discharge those responsibilities that are properly theirs.

WHAT ABOUT REFUNDING BONDS?

Nearly one-fifth of all the people in these United States are today living in some five or more States where the local governments under the States are afflicted with some form of costly constitutional tax limitations, even for debt service. My State is one of them. Need anyone who is only half-way acquainted with the public tax-mind, inquire why these archaic limitation features are not removed? Under existing tax conditions, the possibility of their early removal, is almost unbelievable. Consequently, in most of these jurisdictions, a large amount of bonds are, of necessity, and not by choice, being refunded. Due to tax strikes and tax-reducing rackets, oftentimes over which local governments—particularly municipalities—have little or no control, this necessary refunding process will likely be of large proportions for years to come.

In the absence of some declaration of policy on the part of the proper authority, it can be assumed that under the proposed plan, the income from refunding bonds would be taxable with no alternative remaining to the municipality suffering from constitutional tax limitations—but to issue refunding bonds—pay the increased interest indirectly imposed by the Federal Government, and like it or else.

Aside from all questions of legal authority to impose the tax, one can well wonder at the lack of wisdom or justice of such a procedure between related governments.

WHAT ABOUT RECIPROCAL TAXATION PRIVILEGES—SUCH AS HAS BEEN PROPOSED?

Reciprocity is ordinarily acceptable when it reciprocates. Unfortunately, however, in this instance the offer does not go far enough. What reciprocative revenues might come to the lower levels of Government, will largely fail to reach the Treasury of those levels paying the vast majority of this increased interest cost, viz: The municipalities. Even with the States, it would be something of another "Forty and Eight" case, with probably 40 States or more, receiving less—oftentimes, much less—than they or their instrumentalities would pay as added interest on bonds. Whereas, there might be some seven or eight, that possibly would receive a larger return from taxing Federals than the State and its lower levels of Government would be required to pay in the way of increased interest costs.

If this tax must be imposed, let the reciprocal offer of taxation extended to local governments, include subjection of the vast and fast increasing number of Federal properties of all kinds in local jurisdictions, to all the usual and ordinary local jurisdictional taxes applicable to other similar properties privately owned. When that is done, we would then have something in the nature of true reciprocity, and not merely an empty offer.

BONDS IN COURSE OF CURRENT ISSUE

It is general knowledge that there are constantly large amounts of bonds in the course of issuance and sale. That is particularly true at this time in connection with the bonds being prepared for the seasonal offering in March for April 1st delivery. The market's uncertainty of what may be done by Congress in the next 30 or 60 days—regarding this proposed tax—places all currently proposed issues at a very decided market disadvantage.

In the absence of some declaration of policy on the part of the proper authority, allowing a reasonably sufficient grace, in any event, to sell and deliver tax free, issues already in preparation, there will almost certainly be reflected in the buyers, purchase, the full weight of the proposed tax, whether or not Congress ever imposes it—and all to the disadvantage of the local government.

It is therefore, respectively suggested that some definite policy be promptly declared that will void this disadvantage to the local governments regarding issues in current preparation.

CONCLUSION

The following is respectfully submitted as a summarization:

1. A Federal tax on income from local government bonds is an indirect tax on local governments, and is contrary in principle to the American theory and doctrine of dual sovereignty in Government.
2. The increased Federal revenue resulting from taxation of income from State and local government securities will be, but little more, if any, than the increased interest cost on the part of local governments, as a result of the tax.
3. If this tax proposal is to be further pursued, let there be established a test period of 5 years, or more, during which time only Federal issues will be taxed,

thereby seeking to establish the correctness or fallacy of the Government's claim that the tax will not materially increase interest costs. Let the Federal Government first try its own medicine.

4. Consider that the imposition of the tax will further impair the local government's ability to finance their part of the relief load with the further possibility of the Federal Government having to assume more, rather than less of the financial responsibility, already assumed.

5. The reciprocal privileges offered are wholly inadequate as regards benefits to local governments—particularly municipalities—compared with their added interest costs under the tax. It is an empty offer.

6. Promptly declare a policy of tax-free grace on issues now in course of sale and delivery.

The CHAIRMAN. We will now hear from Mr. Mallery, the manager of the American Municipal Association.

STATEMENT OF EARL D. MALLERY, MANAGER, AMERICAN MUNICIPAL ASSOCIATION, WASHINGTON, D. C.

Mr. MALLERY. Mr. Chairman and gentlemen of this committee, I am here representing the American Municipal Association. This association is the federation of the 40 State Leagues of Municipalities, the membership of which is comprised of 7,300 cities and towns of all population groups.

I request permission to submit for the consideration of the committee a resolution adopted by the American Municipal Association at its annual meeting, October 15, 1938, in Chicago, and resolutions adopted by the State Leagues of Municipalities of Michigan, Minnesota, Maine, Nebraska, Oklahoma, New Jersey, Kentucky, Arkansas, Texas, Florida, Idaho, West Virginia, Alabama, Illinois, North Carolina, Kansas, Utah, and Arizona, by the League of Cities of the Third Class of Pennsylvania, and by the New York State Conference of Mayors and other municipal officials, together with resolutions adopted by certain cities of Virginia, Florida, and other States. Also, a brief statement by Mr. Clifford W. Ham, executive director of the American Municipal Association, discussing the limited extent to which the adoption of the presently proposed legislation for reciprocal taxation can benefit municipal government.

(The resolutions and statements referred to by Mr. Mallery will be found at the end of his testimony.)

I am authorized to represent Mayor James R. Law, of Madison, Wis., in the presentation of his statement, which is made on behalf of 422 municipalities of the League of Wisconsin Municipalities, of which Mayor Law is president.

On January 16, at a State-wide legislative conference attended by 150 city and village officials from all parts of Wisconsin, I was directed to appear before this committee as president of the League of Wisconsin Municipalities, which comprises 422 municipalities, constituting 98 percent of the city and village population of Wisconsin. I will confine my remarks to the practical aspects of the problem. Our legal counsel has prepared an analysis of the legal phases of the subject, but I believe this committee will receive ample testimony on that point.

There is no question that if this country were starting out to devise a perfect tax system for all levels of government—Federal, State, and local—that we would not permit the tax exemptions which are now in controversy. However, this governmental system of ours has been

in existence for a century and a half, and we have built up a system of relationships that is so constituted that if we tinker with one part of it, there may be repercussions at some other point which were not foreseen or completely understood.

Local officials would certainly not contend that the present tax structure in this country is satisfactory. The Federal Government has taken for itself the most promising sources of revenue, the States have used the best available tax sources that remain, while we local units of government are largely left dependent upon the general property tax.

It is quite generally acknowledged by informed persons that, whatever may have been the original situation, the property tax is no longer based on ability to pay. In fact, it can be conclusively demonstrated that the general property tax is more regressive in character than any of the modern forms of taxation, including the sales tax. Everyone admits the undesirable characteristics and effects of the property tax, and yet, taking the country as a whole, the result has been to continually pile burdens on the general-property taxpayer. Increased school costs, relief costs, social-security costs, the cost of modern streets, and other costs have been continually loaded on until in many States the plight of the home owner, farmer, and small-business man has become unbearable. Once home ownership was supposed to have contributed to the stability of this country, and now it is widely stated that it is no longer desirable for a man to own his own home.

In Wisconsin the average general-property tax rate for cities increased from 2.3 to 2.9 percent between 1930 and 1938 on a full-value basis. In some cities where there is little wealth the rates have risen to a point as high as 5 percent. Notwithstanding these increases, Wisconsin cities have cut expenditures and are actually spending less money for general city activities now than they were in 1930, despite population increases. The tax increases resulted primarily from $21,000,000 spent by local governments for relief last year in Wisconsin, and also the large social-security costs paid from property taxes.

I am introducing this discussion of the general property tax burden because of the fact that the effects of the proposals now before this committee will be to materially increase general-property taxes in Wisconsin.

Let us consider first the matter of subjecting municipal salaries to the Federal income tax. The present tax exemption has been a definite factor in fixing municipal salary levels. In order to secure qualified department heads, administrators, and technical men, so that local government may be operated efficiently and economically, it has been necessary to compete with private industry for the proper personnel. In fixing salary rates, the existing tax exemption has frequently been considered in endeavoring to adopt salary scales comparable to private employment.

As a result, if these salaries are to be taxed in the future, they will have to be increased to that extent.

It is true that apparently Federal salaries will also be subjected to taxation. But here local governments will be left holding the bag. Even if the States secure revenue from the taxation of these Federal salaries equal to the added expenses of local governments, which is

doubtful, it must be recalled that only a portion of this State revenue, if any, will find its way into local treasuries. The result will be increased property taxes. It is true that, theoretically, the States can mete out justice to local governments, but it will be recalled that at the beginning I stated that I intended to discuss the practical aspects of the problem. We know the result will be a far greater financial burden for local government.

This, however, is not as serious as the effect of removing the existing tax exemption from municipal securities.

In Wisconsin local governments are making valiant efforts to get out of debt, and our cities have reduced their outstanding bonds by 30 percent in 6 years. However, it has been necessary to issue relief bonds and bonds to finance the P. W. A. program, bonds for sewage disposal and waterworks facilities where communities were not completely equipped, school bonds, and in other similar instances. It is obvious that the taxation of local bonds will increase the cost of borrowing. It appears that the Federal Government will receive no more in revenue than the localities will pay through increased interest cost. Even if the States are permitted to tax Federal securities, little of this tax revenue will find its way into local coffers.

This proposal to tax local securities is another step forward in the centralization of revenues. It is done at the expense of imposing additional costs upon the already overburdened general property taxpayer.

In 1935 the President stated that all levels of government are stepping on each others' toes in the matter of taxation, and that the tax situation needs revision through the working out of a better system of taxation—State, municipal, and Federal. To my mind, what is now being proposed is a step in the opposite direction, in that the Federal Government is again stepping on the toes of local government, so as to further confuse the situation, rather than in the direction of attempting to bring some order out of the present chaos.

It is essential, from the standpoint of municipal government, that something constructive be done. Cities and villages render the services of government of most immediate importance to citizens—police and fire protection, schools and libraries, guarding of public health, sewage, garbage, and other sanitary facilities, streets and street lighting, parks and recreation, and the numerous other activities which our people today consider to be essential parts of their standard of living. Yet these same local governments come at the tail end so far as effective means of raising revenues are concerned.

There must be an end to the long-prevailing tendency to foist more and more financial obligations upon the long-suffering general-property taxpayer. This was clearly recognized by the President in the statement made in addressing a recent Congress when he stated:

> Let us further remember that by far the largest part of local taxes is levied on real estate. To increase this form of tax burden on the small property owners of the nation would be unjustified.

Since the Federal Government has unloaded on local governments a large part of the responsibility for financing the direct-relief and work program, that statement is even more true today than when it was uttered.

(The resolutions, etc., submitted by Mr. Mallery are as fol'ows:)

RESOLUTION ON THE TAXATION OF MUNICIPAL SALARIES AND BONDS

Whereas in the past practically all changes in taxation methods, and the exemptions incident thereto, have discriminated against municipalities by constantly reducing the local tax base in the face of continuing demands for essential governmental services; and

Whereas Federal or State taxation of municipal salaries and bonds will raise municipal costs for these purposes: Now, therefore, be it

Resolved, That the American Municipal Association, cognizant of this past experience, strongly recommends that any proposed changes in the present tax exempt status of municipal salaries and bonds should be reciprocal by actually securing for municipalities, through local taxation of State and Federal property, through a municipal share of State or federally collected income taxes, or otherwise, a revenue sufficient to offset such increased municipal costs.

(Adopted at the annual meeting of the American Municipal Association, held in Chicago, October 15, 1938.)

RESOLUTION OF THE MICHIGAN MUNICIPAL LEAGUE

SALARY TAXATION—CONGRESS SHOULD LEVY ONLY ON FUTURE INCOME OF MUNICIPAL EMPLOYEES

Whereas under the recent decision of the United States Supreme Court in Helvering *v.* Gerhardt the Federal Government may have the supreme power to tax all State and municipal employees, and

Whereas such decision may have the retroactive effect of taxing such employees upon all compensation earned since 1926, and

Whereas retroactive taxation has always been regarded as contrary to American principles of government: Now, therefore, be it

Resolved, by the Michigan Municipal League, That legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future, and be it further

Resolved, That a copy of this resolution be sent to the governing body and chief administrative official of each city and village in the State with a request that this resolution be read at the next regular meeting of such governing body and that it, in turn, adopt a similar resolution for transmission to its Congressmen and Senators; and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Michigan, to the Attorney General of the United States, the Governor, Governor-elect, after he assumes office, attorney general, and attorney-general-elect, of the State of Michigan, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee.

RESOLUTION OF ALABAMA LEAGUE OF MUNICIPALITIES

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees, and.

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926, and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies; Now, therefore, be it

Resolved, by the Alabama League of Municipalities, acting by its executive and legislative committees in session assembled at Montgomery, Ala., on the 28th day of December 1938, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the Alabama League of Municipalities is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the Alabama League of Municipalities hereby opposes the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government's taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and to the members of the Alabama congressional delegation as soon as may be.

RESOLUTION OF THE WEST VIRGINIA LEAGUE OF MUNICIPALITIES

At a meeting of the executive board of the West Virginia League of Municipalities held in Fairmont December 4, 1938, item 10 of the agenda resulted in the following action:

"Upon consideration of the recent Federal Treasury proposal that Congress attempt to (*a*) impose retroactive (12 years) income taxes upon municipal employees, (*b*) tax all outstanding municipal bonds, and (*c*) abolish the tax-free feature of all future municipal bond issues, the league executive board, by unanimous vote, joined other State leagues, Attorney General Clarence W. Meadows, and the National Conference on State Defense in opposing these measures and

"*Resolved*, That no method of accomplishing any of these purposes be adopted other than by constitutional amendment, and that West Virginia Congressmen be advised of this action.

"Attest:

"[SEAL]

HUME K. NOWLAN,
"Executive Secretary."

RESOLUTION OF ILLINOIS MUNICIPAL LEAGUE

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees, and

Whereas the employees of the Illinois Municipal League, along with all other State and municipal employees, now face the imminent danger of paying income taxes upon all salaries earned since 1926, and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved, by the Illinois Municipal League in convention assembly at Rockford, Ill., on the 16th day of September 1938, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future, and be it further

Resolved, That the Illinois Municipal League is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies, and be it further

Resolved, the Illinois Municipal League hereby approves and endorses the program and objectives of the conference on State defense to oppose the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressman representing the State of Illinois, to the Attorney General of the United States, the attorney general of the State of Illinois, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee.

Resolution of North Carolina League of Municipalities

Whereas the Supreme Court of the United States in the recent decision in *Helvering* v. *Gerhardt* "rejected the reciprocal test of tax immunity and returned to Chief Justice Marshall's understanding that the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated, and supreme, taxing power of the Central Government," and

Whereas employees of municipalities are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926, and

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal bonds as well as future municipal bond issues, and

Whereas the Federal Government claims the power to impose the Federal corporate income tax on the revenues of State and municipal agencies, such as power and lights, toll bridges, water supply, and other revenue-producing functions; Now, therefore, be it

Resolved by the North Carolina League of Municipalities in convention assembled at Asheville, N. C., this 6th day of August 1938, That if State securities are to be taxed by the Federal Government, the State's consent should first be obtained through a constitutional amendment, permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal taxation of the revenues of the States and municipalities or of State and municipal agencies; and be it further

Resolved, That congressional legislation should be passed at the next session of Congress limiting any taxation of State officers and employees to salaries which they receive in the future; and be it further

Resolved, That copies of this resolution be sent to North Carolina Senators and Representatives in Congress, and to the Conference on State Defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

Resolution of the League of Minnesota Municipalities

Whereas securities and the income from securities issued by municipal governments are exempt from taxation by the Federal Government, and

Whereas there have recently been proposals that the Federal taxing power be extended to such securities and income, and

Whereas such proposals, if enacted into law, would add to the cost of State and local government by increasing the interest rate on such securities, and

Whereas reciprocally, these arguments apply also to the exemption of Federal securities and the income thereof from State taxation;

Resolved, That the League of Minnesota Municipalities oppose any such attempt unless Federal taxation of the corporate revenues and already issued securities of the States, their subdivisions and agencies is prohibited and unless there is also secured to the States a guaranty of the reciprocal right to tax future issues of Federal securities and the income thereof.

Resolved further, That the League of Minnesota Municipalities oppose taxation of governmental officials and employees' salaries heretofore earned.

Resolution of the Maine Municipal Association

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering v. Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees, and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926, and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved, by the Maine Municipal Association in convention assembled, at Augusta, Maine, on the 9th day of November 1938, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the Maine Municipal Association is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of

the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the Maine Municipal Association hereby approves and endorses the program and objectives of the Conference on State Defense to oppose the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment, and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Maine, to the Attorney General of the United States, the attorney general of the State of Maine, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee.

Resolution of the League of Nebraska Municipalities

Mr. President and members of the League of Nebraska Municipalities:

Your committee on resolutions, having completed its report, begs leave to submit same, as follows:

Sec. III. *Resolution on Federal taxation of municipal revenues, bonds, and salaries.*—Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of States and municipal agencies; now, therefore, be it

Resolved, By the league that Congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further, being distinctly understood that the league does not oppose Federal income taxes on future salaries of municipal officers.

Resolved, That the League of Nebraska Municipalities is opposed to the taxation of State and municipal securities by the Federal Government unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the League of Nebraska Municipalities hereby approved and endorses the program and objectives of the Conference on State Defense to oppose the program and objectives of the Federal Government to tax State and municipal securities except by a constitutional amendment, and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities, or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Nebraska, to the Attorney General of the United States, the attorney general of the State of Nebraska, to the chairman of the Senate Finance Committee, and to the chairman of the House Ways and Means Committee.

Resolution of the Oklahoma Municipal League

Whereas the Federal Government, through an interpretation by the Department of Justice of the decision of the United States Supreme Court in *Helvering* v. *Gerhardt*, claims and assumes the power to tax outstanding State and municipal securities, revenues of State and municipal agencies, and salaries of all State and municipal employees; and

Whereas it is the opinion of the Oklahoma Municipal League in convention assembled that such a plan of procedure by the Federal Government is contrary to the fundamental and well accepted principles of our governmental system, constitutes an unwarranted interference with State and municipal activities, would materially cripple or destroy local self-government, and should be resisted with every proper means: Therefore be it

Resolved, That the Oklahoma Municipal League is vigorously opposed to any Federal policy which may, or may appear, to tax State or municipal securities, or the income of either, or the salaries of employees thereof; and be it further

Resolved, That the Oklahoma Municipal League hereby approves and endorses the program and objectives of the Conference on State Defense consistent with the objectives herein enunciated; and be it further

Resolved, That the executive board of the Oklahoma Municipal League give this matter special attention and emphasis and map out a plan to accomplish the intent of this resolution; and be it further

Resolved, That each delegate to this convention report the adoption of this resolution to his governing body; and it is urged that each city governing body adopt a resolution endorsing this resolution, and that each such resolution be sent to the city's representative and Senator in Congress, and be it further

Resolved, That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee, and to the chairman of the House Ways and Means Committee.

Adopted by the Oklahoma Municipal League in convention assembled, this 22d day of November 1938.

(Signed) J. W. FLINT,
President.

FRANK C. HIGGINBOTHAM,
Executive Secretary.

RESOLUTION OF NEW JERSEY STATE LEAGUE OF MUNICIPALITIES

Whereas certain departments of the Federal Government have recently asserted that the Federal Government has the supreme power to tax the States; and

Whereas upon the basis of such an assertion the Treasury Department now proposes, by act of Congress, to tax the income from municipal bonds; and

Whereas such a tax would greatly increase the cost of municipal financing, and so add to the burdens of local real-estate taxation; and

Whereas as a result of recent decisions of the Supreme Court, many municipal employees may be liable for Federal income taxes on their past salaries from 1926 to date: Now, therefore, be it

Resolved, By the New Jersey State League of Municipalities in Convention assembled:

First. That the municipalities of New Jersey oppose the proposed plan of the Treasury Department to tax the interest on municipal bonds by simple act of Congress, and maintain that no such interference with the fiscal powers of the States should even be considered unless first submitted to the States in proper form of constitutional amendment,

Second. That our league supports the enactment of remedial legislation to set aside any liability of our municipal employees for back taxes on salaries received by them from 1926 to date,

Third. That our league cooperate in the program and objectives of the Conference on State Defense, to the end that the integrity and sovereignty of the States in this nation may be preserved, and

Fourth. That the executive secretary is hereby directed to forward copies of this resolution to the Senators and Congressmen from New Jersey, with the request of the league that they oppose this attempt to raise Federal revenue at the direct expense of local government, with resulting increase in local taxation and the further request that they stand firm on this issue for the principle of State independence and sovereignty.

Unanimously adopted Friday, November 18, 1938.

Attest:

S. S. KENWORTHY,
Executive Secretary.

RESOLUTION OF THE NEW YORK STATE CONFERENCE OF MAYORS

Whereas the Federal Government is considering the enactment of a law providing for the taxation of the incomes from all future municipal bond issues and all municipal utilities, and

Whereas there is grave doubt as to whether the Federal Government can tax such incomes without a constitutional amendment, and

Whereas it is estimated that the taxation of municipal bonds would increase from one-half of 1 percent to 2 percent the interest rate the municipalities would have to pay, and

Whereas this tax would be paid by the real-estate taxpayers, and not the investors in municipal securities; and

Whereas justice dictates that if the Federal Government taxes municipal bonds and revenues and loads an additional financial burden on city and village taxpayers, the States should in turn be given the right to impose taxes on Federal securities and the cities and villages to levy a tax on Federal property within their boundaries; and

Whereas Federal taxation of municipal bonds and revenues would increase the present tax discrimination against cities and villages and their taxpayers: Be it

Resolved, That the New York State Conference of Mayors and Other Municipal Officials, with a membership of 189 cities and villages, is opposed to the taxation of municipal securities and revenues by the Federal Government unless the legal consent of the State is obtained, the reciprocal taxation of Federal securities and revenues is guaranteed and municipalities are permitted to tax Federal property and the Federal Government is required to pay such taxes; be it further

Resolved, That we petition the New York State representatives in the United States Senate and House of Representatives to oppose any legislation taxing municipal securities and revenues unless the reciprocal provisions are included.

RESOLUTION OF THE KENTUCKY MUNICIPAL LEAGUE

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas the employees of the cities in Kentucky, along with all other State and municipal employees, now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved, By the Kentucky Municipal League in convention assembled, at Mammoth Cave, Ky., on the 23d day of September 1938, that congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the Kentucky Municipal League is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the Kentucky Municipal League hereby approves and endorses the program and objectives of the Conference on State Defense to oppose the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Senators and Congressmen representing the State of Kentucky, to the Attorney General of the United States, the attorney general of the State of Kentucky, to the Chairman of the Senate Finance Committee and to the Chairman of the House Ways and Means Committee.

(Signed) RESOLUTIONS COMMITTEE.
L. O. SMITH, *Chairman*.
GUY H. BRIGGS.
JOS. D. SCHOLTZ.
J. B. MORLIDGE.
CECIL C. WILSON.

I, Carl B. Wachs, executive secretary of the Kentucky Municipal League, certify that this is a true and exact copy of the original resolution, which is on file in the league office at Lexington, Ky.

CARL B. WACHS,
Executive Secretary, Kentucky Municipal League.

Resolution of Arkansas Municipal League

Whereas the Supreme Court of the United States in the recent decision in *Helvering* v. *Gerhardt:* "Rejected the reciprocal test of tax immunity and returned to Chief Justice Marshall's understanding that the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercises of the delegated, and supreme, taxing power of the central Government." And

Whereas employees of municipalities are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926; and

Whereas the Federal Government claims the power to impose the Federal corporate income tax on the revenues of State and municipal agencies, such as power and lights, toll bridges, water supply, and other revenue-producing functions: Now, therefore, be it

Resolved, By the Arkansas Municipal League in convention assembled at Little Rock, Ark., this 15th day of December 1938, that if State securities are to be taxed by the Federal Government, the State's consent should first be obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal taxation of the revenues of the States and municipalities or of State and municipal agencies; and be it further

Resolved, That congressional legislation should be passed at the next session of Congress limiting any taxation of State officers and employees to salaries which they receive in the future; and be it further

Resolved, That copies of this resolution be sent to Arkansas Senators and Representatives in Congress and to the Council on State Defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

Resolution of the League of Texas Municipalities

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies; now, therefore, be it

Resolved by the League of Texas Municipalities in convention assembled at Port Arthur, Tex., on the 28th day of October 1938, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the League of Texas Municipalities is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the League of Texas Municipalities hereby approves and endorses the program and objectives of the Conference on State Defense to oppose the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to obtain an absolute prohibition against the Federal Government taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee and to the chairman of the House Ways and Means Committee, and that the sense of this resolution be communicated by the respective members of the association to their Congressional representatives as soon as may be.

Passed and approved this the 28th day of October, A. D. 1938, at Port Arthur, Tex.

Approved:

Wm. V. Brown,
President, League of Texas Municipalities.

Attest:

E. E. McAdams,
Executive Secretary.

RESOLUTION OF TEXAS CHAPTER, MUNICIPAL FINANCE OFFICERS' ASSOCIATION

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies; now, therefore, be it

Resolved by the Texas Chapter, Municipal Finance Officers' Association, in convention assembled at Port Arthur, Tex., on the 26th day of October 1938—

First. The Federal Government should, under no circumstances, be permitted to tax the revenues of local governments or any of their agencies, or the bonds which they have already issued and which are outstanding.

Second. Legislation should be promptly enacted which will prohibit the taxation of the salaries of State and municipal employees, earned in past years, when it was then believed that the said salaries were exempt.

Third. If the income from future issues of State and municipal bonds are to be taxed, as well as the salaries of local government employees, the Federal Government should accord reciprocal privileges to our city and State governments as applying to Federal securities, salaries, and properties.

Fourth. In the absence of a grant of equal reciprocal taxing powers, our fullest resistance should be given to any attempt on the part of Federal Government to tax the income from either bonds presently outstanding or those issued in the future, or salaries paid either in the past, present, or in the future, unless authorized by a proper constitutional amendment.

Fifth. That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee, and to the chairman of the House Ways and Means Committee, and that the sense of this resolution be communicated by the respective members of the association to their congressional representatives as soon as may be.

Passed and approved this the 26th day of October, A. D. 1938, at Port Arthur, Tex.

Approved:

L. L. WILLIAMS,
President, Texas Chapter, Municipal Finance Officers' Association.

Attest:

E. E. MCADAMS, *Secretary.*

RESOLUTION ON FEDERAL TAXATION OF MUNICIPAL, COUNTY, AND STATE REVENUES, BONDS, AND SALARIES

Whereas the Federal Government contends, under the decision by the United States Supreme Court in *Helvering* v. *Gerhardt:*

"That the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated and supreme, taxing power of the Central Government"; and

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal and county bonds, as well as future municipal and county bond issues; and

Whereas the Federal Government also claims the power to impose the Federal corporate income tax on the revenues of State, county, and municipal agencies, such as power, lights and gas, toll bridges, water supply, and other revenue-producing functions; and

Whereas the Federal Government further claims the power to tax the salaries of municipal, county, and State employees, and such employees are faced with the immediate danger of being required to pay a Federal income tax on their salaries earned for every year back to 1926. Now, therefore, be it

Resolved by the Florida League of Municipalities in convention assembled at Pensacola, Fla., this 2d day of December A. D. 1938, That if municipal, county, and State securities are to be taxed by the Federal Government, the consent of the States should first be obtained through a constitutional amendment, permitting the reciprocal taxation of Federal securities in the States should first be obtained through a constitutional amendment, permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal

taxation of any of the revenues of the States, counties, and municipalities, and their respective agencies; and be it further

Resolved, That congressional legislation should be passed at the next session of Congress to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities, counties, and States, and their respective subdivisions and instrumentalities; and be it further

Resolved, That the financial loss to local units of Government and their agencies through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local taxation of Federal property, or service charges in lieu thereof, or for a municipal share of federally collected income taxes, or otherwise; and be it further

Resolved, That a copy of this resolution be sent to each Senator and Representative of Florida in Congress, and to the council on State defense, whose objectives are hereby indorsed insofar as they coincide with the objectives of this resolution.

RESOLUTION PRESENTED AND ADOPTED TO THIRTY-NINTH ANNUAL CONVENTION OF THE LEAGUE OF CITIES OF THE THIRD CLASS IN PENNSYLVANIA, HELD IN READING, PA., SEPTEMBER 1, 2, 1938

Continuing efforts are now being made in the United States to subject to Federal taxation the income from State and municipal bonds, the salaries of State and local employees, and in some cases the revenues of public bodies. The stated purpose of such taxation is to increase the revenues of the National Government. There have been some intimations that the taxation of public salaries might even be made retroactive for certain groups of employees.

The convention condemns any attempt to make retroactive any ruling which would permit the collection of income taxes on the salaries of any group of public employees heretofore considered exempt. Such a policy would be a punitive measure unduly penalizing a group which has acted in good faith. Nor should any attempt be made to tax the income on State and local securities already outstanding.

In the interest of equity in taxation the convention is not opposed to taxation of the salaries of State and local employees by the Federal Government provided that the Federal Government at the same time permits the taxation of Federal employees by States having State income-tax laws.

While the convention is opposed to the Federal taxation of the income from State and municipal bonds already outstanding because such a measure would seem unfair to the present holders thereof, it opposes the taxation of State and municipal bonds to be issued in the future on a different basis. The net result of such taxation would be an increase generally in the cost of local government with a corresponding increase in Federal revenues. This tends toward a greater centralization of revenues in the Federal Government with a consequent increase in the revenue difficulties of the local governments.

Furthermore, the convention is opposed to the taxation of revenues or income of public bodies properly organized as such whether they are performing services generally classified as governmental functions or whether they are performing so-called "proprietary" activities.

The convention believes that the chief issues involved in the new types of taxation are the further centralization of power in the Federal Government and the consequent weakening of local governments and therefore believes that the discussion should be viewed in that light.

This convention condemns any attempt on the part of the Federal Government to tax the revenues of the States or their municipalities, and any attempt to tax State or municipal bonds, or the salaries of State and local governmental employees unless and until the consent of the States is first obtained through a proper constitutional amendment.

RESOLUTION OF THE IDAHO MUNICIPAL OFFICERS' ASSOCIATION

To the president and members of the Idaho Municipal Officers' Association, in convention assembled in Boise, Idaho, on December 7 and 8, 1938.

We, the undersigned special committee to which was referred the consideration of recent proposals of the Federal Government to tax the revenues of the States, counties, and municipalities, or their agencies, and the income on their bonds which are now outstanding, and also to tax future issues of bonds, and also to collect taxes on the salaries of officers and employees of States and municipalities earned

from the year 1926 to the present time, do hereby respectfully report and recommend the adoption of the following resolution:

Whereas the Idaho Municipal Officers' Association has given due consideration to the threatened Federal proposal to tax the securities and bonds of the States and municipalities, and their agencies, which are now outstanding or which may hereafter be issued, and being convinced such legislation will cause:

(1) Depreciation of the value of general obligation bonds to the unjust and inequitable loss of their owners and holders;

(2) Local improvement special obligation assessment bonds to become unsalable;

(3) Prevent or seriously retard the making of desirable and essential public improvements which have for their object the general welfare of municipalities;

(4) And increase the cost of marketing and interest rate on such securities, which increased cost must be borne by the taxpayers, and the resultant increase in the cost of municipal government, and necessarily decrease efficiency in municipal Government, and

Whereas we further believe that, as the officers and employees of the States and municipalities, and their agencies, have felt their salaries and income secure from taxation and that such exemption was strictly within the law, to now retroactively collect taxes on such income for past years from 1026 would be an unjustified burden; now, therefore be it

Resolved, I. That the Idaho Municipal Officers' Association is opposed to the removal of the exemption on the securities and bonds of States and municipalities, and their agencies, whether now outstanding or hereafter to be by them, or either or any of them, issued, except by their consent, and unless it be done by amendment to the Constitution of the United States, and providing that the States shall have the reciprocal power to tax Federal securities for revenue and sufficient to provide revenue to offset such increased municipal costs.

II. That we are opposed to the collection of income taxes on the salaries of the officers and employees of States and municipalities, retroactively.

III. That we urge our Representatives in the Congress of the United States to oppose all proposed legislation having for its object the removal of the exemptions on the securities hereinbefore mentioned except as hereinbefore provided, and to support all legislation proposed to prohibit the collection of the retroactive taxes hereinbefore mentioned.

IV. That a copy of this resolution was sent to: Hon. Wm. E. Borah, United States Senator; Hon. D. Worth Clark, United States Senator-elect; Hon. Compton I. White, Representative; Hon. Henry Dworshak, Representative-elect; Hon. J. W. Taylor, Attorney-General; Conference on State Defense.

Respectfully submitted.

GEO. C. HUEBENER,
Chairman.
R. LEWIS ORD,
Mayor of Nampa.
HARRY L. HARPSTER,
Mayor of Burley.

LEAGUE OF KANSAS MUNICIPALITIES

At the annual meeting of the League of Kansas Municipalities, on the 28th day of September, 1938, the following motion was carried:

The League of Kansas Municipalities requests our Senators and our Representatives in the National Congress to pursue such action as will preserve to the people of our respective communities the right to govern themselves within those communities, and that they should vote against each, every, and all measures that are calculated to our or may have the effect of destroying the local government of the communities, placing a burden upon local governments, and of reducing the efficiency of the local governments or of injurying their credit or increasing their debt burden or the charges therefore.

(Motion carried.)

At the annual meeting of the State Municipal League of Utah, September 16, 1938, their resolution No. 6:

That any Federal taxation of municipal bonds and salaries should be reciprocal through a municipal share in State and Federally collected revenues, but not opposed to a Federal tax on salaries providing the same reciprocal right is granted to State to tax Federal officers and agencies.

At the annual meeting of the Arizona Municipal League, November 26, 1938, their resolution No. 6:

To the United States Congress, urging that the present tax-exempt status of State, county, and municipal revenues, bonds, and salaries be maintained.

RESOLUTION OF THE COUNCIL OF THE CITY OF NEWPORT NEWS

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees; and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1926; and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved by the Council of the city of Newport News, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the city of Newport News is opposed to the taxation of State and municipal securities by the Federal Government unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or revenues of State and municipal agencies; and be it further

Resolved, That certified copies of this resolution be sent to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and also to Senators Carter Glass and Harry Flood Byrd, and to the Representatives in Congress from the State of Virginia.

RESOLUTION OF THE COUNCIL OF THE CITY OF PORTSMOUTH, VA.

Be it resolved by the Council of the city of Portsmouth, Va., That there should be no taxation of State municipal securities by the Federal Government unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities and prohibiting Federal taxation of State and munfcipal revenues or revenues of State and municipal agencies.

Adopted January 10, 1939.

L. C. BRINSON, *City Clerk.*

RESOLUTION OF THE COUNCIL OF THE CITY OF NORFOLK

Whereas the Council of the City of Norfolk is advised that certain Federal agencies have interpreted the decision of the United States Supreme Court in the recent case of *Helvering* v. *Gerhardt* as empowering the Federal Government to tax all State and municipal employees, State and municipal revenues and securities, as well as the revenues of State and municipal agencies; and

Whereas it is the judgment of the council that such taxation will be detrimental to the interests of city employees and seriously handicap city finances, and it desires to record its opposition thereto: Now, therefore, be it

Resolved by the Council of the City of Norfolk:

SECTION 1. That if it is the intention of the Federal Government to tax State and municipal officers and employees, suitable congressional legislation should be passed limiting such taxation to future salaries.

SEC. 2. That there should be no taxation of State and municipal securities by the Federal Government unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities and prohibiting Federal taxation of State and municipal revenues or revenues of State and municipal agencies.

SEC. 3. That the city clerk be, and he is hereby, authorized and instructed to forward certified copies of this resolution to the chairman of the Senate Finance Committee, the chairman of the House Ways and Means Committee, and to the Representatives in Congress of the State of Virginia.

Adopted by the Council of the City of Norfolk, January 10, 1939.

JNO. D. CORBELL, *City Clerk.*

RESOLUTION OF THE CITY COMMISSION OF THE CITY OF JACKSONVILLE, FLA.

FROM THE MINUTES OF THE CITY COMMISSION, JACKSONVILLE, FLA., SPECIAL MEETING, MONDAY, JANUARY 23, 1939

Whereas this board is informed that the Federal Government contends, under a decision by the United States Supreme Court in *Helvering* v. *Gerhardt* "that the principle of immunity protected the Federal Government against taxation by the States but did not necessarily shield the States against the exercise of the delegated, and supreme, taxing power of the Central Government," that it has the power to tax outstanding as well as future issues of municipal and county bonds; to impose the Federal corporate income tax on the revenues of State, county, and municipal agencies such as power, lights, and gas, water supply, and other revenue producing functions; and to tax the salaries of municipal, county, and State employees, even so far as to make same retroactive over a period of more than 10 years: Now, therefore, be it

Resolved by the City Commission of the City of Jacksonville, Fla., in special session this 23d day of January, A. D. 1939, That if municipal, county, and State securities are to be taxed by the Federal Government the consent of the States should first be obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities in the State, and including an absolute prohibition against any Federal taxation of any of the revenues of the States, counties, and municipalities, and their respective agencies; be it further

Resolved, That congressional legislation should be passed at the present session of the Congress to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities, counties, and States, and their respective subdivisions and instrumentalities; and be it further

Resolved, That the financial loss to local units of government and their agencies through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local taxation of Federal property, or service charges in lieu thereof; or for a municipal share of Federally collected income taxes, or otherwise and be it further

Resolved, That a copy of this resolution be sent to each Senator and Representative of Florida in Congress, and to the Council on State Defense, whose objectives are hereby endorsed insofar as they coincide with the objectives of this resolution.

[SEAL] M. W. BISHOP,
Secretary, City Commission.

RESOLUTION OF THE MAYOR AND CITY COUNCIL OF THE CITY OF HARTSHORNE, PITTSBURG COUNTY, OKLA.

That whereas it has come to our knowledge that the United States Treasury and the United States Department of Justice, has made a ruling that the income from municipal-owned utilities, also bonds of municipalities, are subject to and have for the past 12 years been subject to a Federal income tax; that this has abrogated a long understanding that the same were exempt from said tax; that if this is sustained, or if Federal legislation is enacted carrying into effect this ruling it will work a great hardship on municipalities, and especially those whose income in the past few years have not been sufficient to carry on municipal affairs: Therefore be it

Resolved by the mayor and City Council of the City of Hartshorne, That they protest and seriously disapprove the enforcement of this rule, and protest the enactment of any legislation carrying the same into effect. That a copy of this resolution be transmitted to the Honorable Elmer Thomas, to the Honorable Josh Lee, United States Senators, and to the Honorable Wilburn Cartwright, Congressman from the Third District of Oklahoma.

Passed this 3d day of January 1939.

——— ———, *Mayor.*

Attest:
[SEAL] EARL YATES, *City Clerk.*

RESOLUTION OF THE COMMISSION OF CORAL GABLES, FLA.

RESOLUTION NO. 1875

Whereas the Federal Government contends under the decision by the United States Supreme Court in the case of *Helvering* v. *Gerhardt* that the principle of immunity from taxation protects the Federal Government against taxation by

the several States but does not necessarily shield the States and their governmental units against the exercise of the delegated and supreme taxing power of the Federal Government; and

Whereas the Federal Government now claims the power to tax the outstanding issues of municipal bonds and securities, as well as future issues; and

Whereas the Federal Government also claims the power to impose the Federal corporate income tax on the revenues of municipal proprietary revenue-producing functions and operations; and

Whereas the Federal Government further claims the power to tax the salaries of municipal employees, and that such authority may include the back assessment of such taxes for each year back to 1926: Now, therefore, be it

Resolved by the Commissioner of the City of Coral Gables, Fla.:

1. That if municipal, State, and county securities are to be taxed by the Federal Government, the consent of the several States should be obtained first through a constitutional amendment permitting the reciprocal taxation of Federal securities by the several States.

2. That congressional legislation should be enacted specifically relieving from Federal taxation any and all revenues of municipalities and their agencies.

3. That congressional legislation should be enacted to prevent the retroactive application of any Federal tax upon the officers and employees of municipalities.

4. That the financial loss to the States and their local units of government through any Federal tax upon their bonds and securities and the salaries of their officers and employees should be offset by making adequate provision for local taxation of Federal property, or service charges in lieu thereof, or for the municipalities to share in the federally collected income taxes, or otherwise.

5. That a copy of this resolution be sent to each Senator and Representative of Florida.

I, G. N. Shaw, clerk of the city of Coral Gables, Fla., do hereby certify that the above and foregoing is a true and correct copy of Resolution No. 1875, passed and adopted by the commission of said city on December 13, 1938.

Witnesseth my hand and the official seal of the city of Coral Gables, Fla., this 20th day of January A. D. 1939.

[SEAL] G. N. SHAW, *City Clerk.*

STATEMENT OF CLIFFORD W. HAM, EXECUTIVE DIRECTOR, AMERICAN MUNICIPAL ASSOCIATION

RECIPROCAL POWERS OR RECIPROCAL BENEFITS

In common with the League of California Municipalities and many other organizations of municipalities and public officials, the American Municipal Association has considered carefully the proposals for reciprocal taxation of State and municipal securities and of the incomes of State and municipal employees. Throughout, the association has considered the municipal effect of this proposal. As originally proposed, three elements were involved which, fortunately, in subsequent discussions have been separated. It is essential that each of these elements be considered as a separate proposal and reviewed on its own and separate merits: (1) That by proper congressional action the Internal Revenue Department be authorized to not make any claims for retroactive assessment and collection of taxes on incomes of State and municipal employees heretofore earned; (2) the application of the Federal income tax to salaries of State and municipal employees; (3) the application of the Federal income tax to income derived from State and municipal securities.

The President has recommended to Congress on two occasions that the Federal Government should be given the power to tax the employee incomes and securities of States and their subdivisions, and that the States should be given like, or reciprocal, power to tax Federal securities and salaries. With the President's proposal before it, the American Municipal Association, by resolution of its annual conference in October 1938, proposed that "any changes in the present tax-exempt status of municipal salaries and bonds should be reciprocal." The association has taken this position because (1) "in the past, practically all changes in taxation methods, and exemptions incident thereto, have discriminated against municipalities by constantly reducing the local tax base in the face of continuing demands for essential governmental services;" and (2) because "Federal or State taxation of municipal salaries and bonds will raise municipal costs for these purposes—costs which should be offset by revenue sufficient to meet them."

Cities are concerned, too, with possible future interpretations of the phrase of the sixteenth amendment "from whatever sources derived," as applied to the power of the Federal Government to lay income taxes. Does a next step after the taxing of salaries and incomes from securities mean the taxing by the Federal Government of the income from State and municipal corporations and utility services? Does it mean reciprocally that they must consider at a future time taxation by the States and cities of the Federal governmental corporations and properties? Some Federal agencies now pay local taxes on real-estate holdings; others do not; while still others (the Federal Housing Authority, for instance) urge the waiver of local taxes on local housing projects as a subsidy for improved housing.

The association has come to the conclusion that an important point around which the whole argument revolves is the interpretation of the word "reciprocal." There is a great difference between the interpretation of the word "reciprocal" as discussed in connection with the proposals before Congress and as contained in the resolution of the American Municipal Association. From the Federal standpoint, reciprocal taxation has been taken to mean that the Federal Government shall undertake a type of income taxation which shall be open in equal measure to the States. In other words, the Federal Government is interested primarily in the power to tax, but as the American Municipal Association uses the phrase from the municipal standpoint, reciprocal taxation means the provision of offsetting or compensating revenue from whatever source derived. The association believes that what American cities must have are reciprocal benefits.

This great variance in the meaning of "reciprocal" has a simple explanation—namely, that the Federal Government may levy an income tax, while as a practical proposition a municipality may not. In order to secure revenue sufficient to offset increased costs, therefore, municipalities have got to look to "local taxation of State and Federal property, a municipal share of State or federally collected income taxes," or to other sources, as the American Municipal Association's resolution puts it. The Federal Government, on the other hand, needs only extend the scope of its income-taxing power.

It should be axiomatic that the basic objective of any change should be more equitable taxation, and not merely the substitution of one set of inequities for another. Any change in the present situation which does not make offsetting revenue as readily available to municipalities as the income tax is to the Federal Government will neither be "reciprocal" nor equitable. On the other hand, any change that reduces inequalities as the result of a fair and unbiased examination of the whole problem of intergovernmental tax immunity will be welcomed as a real first step toward more orderly taxation in the United States.

What is needed and what the cities have been urging for many years is a complete revision of the whole tax structure, Federal, State, and local, looking toward the elimination of overlapping and conflicting tax provisions. To attempt piecemeal adjustments of these inequalities but confuses the issue more.

The cities also insist that the establishment of proper machinery for the administration of the tax is one problem, but that it does not follow that that unit of government which is best equipped to administer the tax is therefore necessarily best equipped to spend funds derived therefrom and to render public service financed thereby. Coincident with the readjustment of the tax structure and the elimination of overlapping and conflicting tax problems should and must go, the redistribution of revenues and the realinement of governmental functions among the levels of government to the end that those levels which can best administer and collect any certain tax should be charged with that duty and that the funds collected thereby should be distributed to the different levels of government in proportion to their abilities to best render the functions and spend the public funds in support thereof.

The CHAIRMAN. Mr. Costello.

STATEMENT OF JOSEPH K. COSTELLO, GENERAL MANAGER OF THE DELAWARE RIVER BRIDGE, REPRESENTING THE PUBLICLY OWNED TOLL BRIDGE COMMITTEE OF THE AMERICAN TOLL BRIDGE ASSOCIATION

Mr. COSTELLO. Mr. Chairman and gentlemen of the committee: The committee on publicly owned toll bridges of the American Toll Bridge Association has asked me to appear before this committee to present certain facts for consideration by your honorable body.

The publicly owned toll bridges of the country are vitally interested in the proposal to impose a Federal tax upon the income of bonds issued by the States and their subdivisions. Nothing in recent years has disturbed the management of these bridges so much as this proposal. We submit that these bridges are a most important factor in the economic life of this country. In every case, they were built in response to a demand from a public handicapped by lack of means of crossing rivers swiftly, advantageously, and safely. When the country became a nation on wheels, the ferries could not accommodate the demand upon them. Out of sheer necessity, great bridges and tunnels were constructed and there can be no doubt that these have contributed materially to the progress and prosperity of the Nation.

These bridges could not be built by private capital. Even under the most favorable conditions, a new bridge is not to be classed as a prime investment. Were it otherwise, of course, private capital, seeking a means to put its funds to work, would have forestalled the State governments in undertaking these projects. The usual history of a bridge is that many years elapse between the original demand for the project and the actual construction thereof. For example, in the case of the Delaware River Bridge between Philadelphia and Camden, with which I am most familiar, the first plans were prepared in 1818 and ground was broken in 1922. While it does not always take 104 years to crystalize the demand of the public into concrete and steel, it nevertheless remains that much arduous work must be done by the proponents of the enterprise before anything is accomplished.

Regardless of how scientifically calculated, forecasts of future traffic are notoriously often unsound. Estimates of costs and probable return are prepared. There may be no doubt that the bridge is urgently needed but the question arises as to whether it can pay its own way. Private investors show no disposition to gamble their dollars and they cannot be blamed because the country is dotted with bridges that have failed financially.

When the public demand grows great enough, the aid of the States is solicited. Sometimes, when the bridge lies between States separated by a river, the two join and appropriate from their own hard-pressed treasuries toward the cost of the structure. Up to the last 15 years, this was the common procedure. Bridges were built on the understanding that tolls would be charged until the original cost was met and the structure would be free to the traveling public. With the tremendously increased burden of taxation in recent years, many of the States found this procedure no longer possible.

The Port of New York Authority and, later, the Delaware River Joint Commission introduced a new development in the financing of great river crossings. The Port of New York Authority issued its own bonds and repaid New York . New Jersey for the appropria-

tions which made the Holland Tunnel possible. The Delaware River Joint Commission followed suit and issued its own bonds to repay Pennsylvania, New Jersey, and the city of Philadelphia every dollar, with interest, that was advanced for the building of the Delaware River Bridge. This was followed in other parts of the country.

These bonds were sold to the public with nothing behind them but the revenues of the structures. In the case of the Delaware River Bridge, the Commonwealth of Pennsylvania and the State of New Jersey retain title and no mortgage was created upon the structure. If the bridge continues to enjoy sufficient traffic to meet operating and maintenance charges, the bondholders receive their semiannual interest and, each year, some of the bonds are matured.

The States, by legislative enactment, expressly forbid the commission to levy any taxes other than tolls upon vehicles using the structure. The purchasers of these bonds might be said to be adventurers. They invested in a rather hazardous field. They knew, if the bridge were to be a gold mine, that the shrewd scouts of private capital, presumably, would have seen the treasure before the States did. In calculating the return from their investment, they weighed heavily the consideration that, inasmuch as the bridges were to be public enterprises, the income from the bonds would be immune from Federal taxation. You might go so far as to say this immunity was the bait. In any event, it was an important consideration. The people who bought bonds backed only by bridge revenues were courageous.

The various commissions and authorities in control of these enterprises the country over gave as much thought to designing the financial structure as their engineers did in designing the towers, anchorages, and cables. Interest rates upon the bonds had to be calculated carefully to attract investors but the authorities and commissions figured that successful operation of their enterprises would provide a seasoning for the bonds and, in nearly every case, provided that the original bonds could be called within a reasonable period.

In the case of the Delaware River Bridge, our interest rate is 4½ percent, entirely too high in view of the present market conditions. At the present time, we have outstanding $37,000,000 bonds but they are callable in 1943.

Senator TOWNSEND. May I ask the total cost of the bridge?

Mr. COSTELLO. The total cost of the bridge originally was $50,000,000.

Senator TOWNSEND. And you now owe $37,000,000?

Mr. COSTELLO. We now have $37,000,000 of outstanding indebtedness. We have paid off as you see $13,000,000.

Every other commission and authority has in mind the refunding of their issues at the callable date. If the Federal Government is to tax income from bonds issued by these State agencies, the prospects of refinancing are decidedly dimmed. The bankers with whom we have been in contact advise that removal of the immunity from bond income will result in an increased expense of from one-half to 1 percent. If the immunity is lost, it will be a difficult question as to whether it would be advantageous to recase the financial structures of these bridges at the callable date or whether it would be better to permit the original issue, which I assume will remain immune, to continue until all the bonds are paid off.

The people who use these bridges pay tolls with the expectation that, at the earliest possible date, the structures will be free to the traveling public. They demand and are entitled to receive every advantage from economic management. On all publicly owned toll bridges, the rates of toll are fixed as low as possible in view of operating costs and bond charges. Most of these authorities and commissions have issued serial bonds in which the amount maturing each year steadily grows until the investment is canceled by maturity. Economic administration requires that interest rates be kept as low as possible to insure the financial stability of the project. Riveted fast into the financial structure of many of our bridges, is the factor that at some subsequent time the bond-interest requirement can be materially reduced. If this possibility vanishes with the immunity hitherto enjoyed, bridge managements must undertake a frantic search for additional revenue.

Nearly all bridge bond indentures contain a provision that the rates of toll must always be sufficient to meet bond requirements. The alternative, you may say, is to increase toll rates, but this is a measure which would be hotly resented by the public and one that cannot be guaranteed to produce desired results. An increase in toll rates means a reduction in the volume of traffic but, even more important than the effect upon the bridges already built, is the restriction that would be imposed upon the building of new bridges and tunnels.

This country needs many additional river crossings and some are so monumental that only a public enterprise can risk the undertaking. Funds to build these structures can be secured only from the public. The States or the authorities they create must bid for the money against private enterprises which offer much less risky avenues of investment than bridge and tunnel building.

Traffic upon the existing bridges has increased greatly in the last 10 years. On the Delaware River Bridge, tolls were collected from more than 74,000 vehicles on 1 day last summer. The time is not so far away when the facilities of this bridge will be taxed and another bridge or, preferably, a tunnel must be built. The only way to obtain the funds is to offer some inducement to the public to invest.

The managers of publicly owned bridges feel that Federal taxation of bridge bonds is the first step toward Federal taxation of commission and authority incomes. It would be almost impossible to operate any of these bridges at the present toll rates if the Federal Government taxes income from operations. In every case, the margin above operating expenses and bond-service charges is very small. Federal taxation would wipe out this margin. Publicly owned toll bridges play an important part in linking this Nation together. In time of national emergency, they would prove of incalculable value for the rapid transportation of our defensive arms.

Rather than limit the construction of these projects, the Federal Government should do everything in its power to aid. We submit that the people of the United States who own and support these publicly owned toll bridges should have a right, through their respective States, to voice their wishes upon this vital question.

The CHAIRMAN. Mr. McShane.

STATEMENT OF O. F. McSHANE, COMMISSIONER OF THE INDUSTRIAL COMMISSION OF UTAH

Mr. McSHANE. Mr. Chairman and gentlemen of the committee, if the committee please, I appear here as representative of the Industrial Commission of Utah. My commission is, by statute, given charge of the State insurance fund, the combined injury and benefit fund and the firemen's pension fund. These funds have been held by the supreme court of Utah to be trust funds and we are limited by law in the type of securities in which we may invest those funds. With the premiums paid for the benefit of laborers we have purchased and hold in our surplus and reserves, a large amount of State and municipal bonds.

For 18 years I have been in direct charge of the State insurance fund and have supervised the investment of those reserves. During this period I have purchased, pursuant to our statute, over $2,000,000 worth of municipal securities. In the discharge of this duty it has been necessary for me to familiarize myself with the market conditions and the factors which go to make up the interest rates on the public securities in which we place our funds. On the basis of that experience I have been able to appraise the estimate made before the committee by Dr. Harley L. Lutz, professor of public finance of Princeton University. In my opinion, he has made a very conservative estimate when he says that the elimination of the immunity of municipal securities will raise the interest rate which local governments must pay by at least 60 points or six-tenth of 1 percent on the principal.

In considering the purchase of securities in which to invest the surplus and reserves of the State insurance fund I have also had to familiarize myself with the fiscal affairs of our Utah municipalities. Our holdings at the present time, embrace many issues on which municipalities are paying a much higher rate of interest than that at which they would borrow under present market conditions. Naturally, these municipalities are, at the present time, straining every effort to refund these outstanding securities and effectuate a savings in their financing costs which they are sorely in need of. Inevitably, their entire refunding program would be seriously jeopardized if the new securities have to be issued on a taxable status or basis.

Because of this refunding situation, the Treasury is not quite accurate when it says that its proposal is to tax only future issues of public securities and not those already outstanding. Securities which will be issued in the future will in the main be part of a refunding program. And from the point of view of the municipalities in whose securities our commission invests, these refunding bonds are really part of the outstanding debt. In other words, even if the Treasury's proposal to end immunity could be restricted to future securities, the present credit position of Utah municipalities will be seriously affected.

After all, it must be apparent to those who are informed that the burden of increased interest rates will fall upon the municipalities and not upon the purchaser. This being true, the Federal Government will be imposing a burden which must fall directly upon the real-estate taxpayer of the affected municipality. The end result will be that it will be real estate of our cities and towns which will have to pay for this advance in the interest rate and for this loss of immunity.

If the plan is to increase the tax contributions of the holder of these bonds, it must fail miserably.

In some of the municipalities of Utah the effect would be even more serious. Of course, our cities and towns which will be hardest hit, and would have to stand the greatest increases in their interest rates, would be the poorer municipalities—those in a weaker financial position. Some of them would be unable to absorb the tax at all. We have a statutory restriction in Utah on the rate of real-estate tax which a municipality may impose. If a financially weak town is already at the limit of the permissible real-estate tax rate, I don't see that it could do anything but go into bankruptcy.

Of course, my commission is vitally interested in anything that threatens the fiscal stability of the municipalities whose securities we hold. If their credit is threatened, their ability to continue paying the interest and principal of our holdings will be jeopardized. And then the maimed workmen, the widows of laborers killed in industrial accidents, and their children must be the sufferers.

In view of our commission's responsibility to care for the money which must be devoted to those who are in such desperate need, we are naturally disturbed by the position taken by the Department of Justice and the Treasury Department with regard to the Federal power to tax the income of the securities which we hold. The conclusions reached by the Department of Justice as to the Federal power are so sweeping that we must register our protest to assertions of Federal power that, if sustained by the courts, could actually reach the funds themselves, as well as the interest rate.

I don't know if the Treasury Department would care to propose legislation at this time which would tax the interest on the bonds we hold. And I feel confident that the Treasury would not propose to tax the premiums which we receive for Utah laborers on the theory that they were "income from whatever source derived" under the Treasury's interpretation of the sixteenth amendment. The Treasury and the Department of Justice would not want to tax us in that way at the present time. But they actually have come out and said before this committee that they have the power to do so. They have claimed that the Federal Government has the power to tax the States themselves because, as they say, only the Federal Government is supreme and only the Federal Government is entitled to immunity. They have claimed the power, not only to tax the interest on future bonds held by public pension systems and compensation funds like ours, but even the power to tax the interest on outstanding bonds, such as those we hold.

At the present time, under the law as it stands, Congress has no power whatsoever to tax the income on our securities or the premiums received by our funds. It is no answer to the dangers I have pictured that Congress might give us a statutory exemption in place of our present constitutional immunity. An exemption which can be given by statute, can be taken away by statute. You gentlemen might give us an exemption; but the next Congress could take it away.

No one can read the Department of Justice study without becoming convinced that the Department has based its argument on one fundamental conclusion—that the Federal Government is the supreme taxing power; that it may tax the income from the States and their political subdivisions whether they like it or not, and that any permission to the States to tax Federal income would continue only at

the will of Congress. The Department of Justice claims the constitutional right to tax the States; it therefore concludes that the Federal Government's right is permanent. But any exemption which will be given to the States and their municipalities and such funds as our own and, indeed, any reciprocal right to the States to tax Federal securities might prove a very transitory permission. What the Department is willing to concede to the States would rest upon a mere act of Congress which could be repealed at any time. We would, in that event, lose our exemption and could be taxed at the will of our master.

We are at this point offered an opiate and an assurance that we need have no fear, as the Members of Congress would at all times be taxing their own constituents. This cannot satisfy. It is too easy to conceive of so-called emergencies which would require the burden of increased taxes. And, of course, emergency taxes have too often in the past become permanent taxes. In making this statement, I am only expressing a fear for the future if we surrender the sovereign and constitutional immunity of the States now.

I have every confidence in the Treasury and in the present Congress. But if the Treasury's proposal is adopted it will destroy the constitutional balance of power hitherto existing between the States and the Federal Government.

If this proposal to tax the States were effected by statute, it would not even achieve the objectives sought. It would be passed in the wishful hope that the Supreme Court could be induced to reverse a doctrine to which it has held since the days of Chief Justice Marshall. It would be bound to be litigious. It would, in the light of the length of such litigations on such questions in the past, only delay the final determination for a greater period of time than the submission of a constitutional amendment to the people. *Helvering* v. *Gerhardt*, the case which the Department of Justice says reversed the immunity of public employees' salaries was in the courts for over 4 years. The last three amendments to the Constitution were adopted in an average of 18 months.

We should not fear to trust the people to pass on a constitutional amendment. They should have the final word in deciding a matter of this kind.

On behalf of the Industrial Commission of Utah, I respectfully submit that the objective of the President can best be achieved by the submission of a constitutional amendment which would guarantee to the States and municipalities and to such funds as our own, the protection from Federal taxation which we must have and which would further guarantee the right to tax Federal income reciprocally. Only in that way will we avoid a challenge to the independence of the States. Only in that way will we prospect and perpetuate the harmonious balance of power between the States and the Nation.

The CHAIRMAN. Mr. Kershner.

STATEMENT BY W. E. KERSHNER, SECRETARY, STATE TEACHERS RETIREMENT SYSTEM, COLUMBUS, OHIO

Mr. KERSHNER. Mr. Chairman and gentlemen of the committee, is Federal taxation of State and municipal bonds fair or unfair, just or unjust, and what would be its effect upon local and State government?

Federal taxes on the income from State and municipal bonds will raise interest rates. Since interest on bonds is paid by local real property taxes in nearly all cases, it simply means an increase in the taxes on real property to pay an increased interest rate in order that the Federal Government may collect the increase from the holder of the bonds. In some municipalities revenue bonds have been issued for installing waterworks, electric light plants, and other utilities. The taxation of interest on these bonds would increase utility rates in the same proportion as a tax on straight municipal bonds would increase the tax rate.

During the last few decades the Federal Government has continually broadened its field of taxation until local governments and schools are being starved, but it has never before made a serious effort to impose a tax on the States and cities, that would in effect constitute a tax on real estate.

Federal taxation of local taxes either by the taxation of the income from State and municipal bonds or the income of local employees is a direct tax on local taxes and might be gradually extended until local government would cease to exist. Notwithstanding the contraction of physical boundaries and the extension of interests and contacts by improved methods of transportation and communication, the fact remains that the security, health, housing, education, and happiness of the people depend almost entirely upon the services rendered by local governments than upon those of the National Government.

We ought to remember that every dollar collected by the Federal Government in taxes is paid by someone living in a State and in a county or municipality of the State, and that in the absence of an equitable division between Federal and State governments of the field of taxation it becomes increasingly important to the States and municipalities to retain at least the small field still left to them.

Ohio bonds issued prior to 1913 were tax free. From 1913 until 1931, when an amendment to the constitution was adopted providing for the classification of property for taxation, these bonds were taxed "at their full value in money." The result was a decided increase in interest rates. In 1921 the 22 Ohio cities having city teachers' retirement systems, transferred their assets and liabilities over to us on an actuarial basis. Among these assets were $400,000 in bonds issued prior to 1913. These were sold on bids and the proceeds invested in new taxable bonds at an increased interest rate and yield of 2 percent. This spread of 2 percent in income between taxable and tax-free bonds gradually reduced as the State made but feeble efforts to collect taxes on them. About the only time it was collected was when the owner dropped dead and the bonds were found in his safety deposit box. The ease with which this tax could be evaded gradually decreased the spread, and after the passage of the intangible tax law in 1931, the evasion gradually stopped because the tax was not enough to justify the risk. But a spread of ½ percent to 1½ percent still continued.

In the examples I shall give there is no guesswork. These are actual market quotations and all during the last 3 months of 1938.

Akron tax-free 4-percent bonds, due in 1942, were offered on a 3-percent basis, while Akron taxable 4¼-percent bonds, due in 1944, were offered at 4.40 percent, and 4¼-percent bonds, due in 1940, were offered at 4.35 percent.

Cincinnati tax-free 4-percent bonds, due in 1942, were offered on a 1.25-percent basis, while Cincinnati taxable bonds were selling around 2 percent—a spread of 0.75 percent. Cincinnati tax-free 3½-percent bonds, due in 1965, were offered at 1.50 percent, while Cincinnati taxable 5-percent bonds, due in 1965, were offered at 2.35 percent—a spread of 0.85 percent.

Cleveland tax-free 4-percent bonds, due in 1952, were offered at 2.15 percent, while Cleveland taxable 4½-percent bonds, due in 1952, were offered at 3.10 percent—a spread of 0.95 percent.

Columbus tax-free 4-percent bonds, due in 1947, were offered at 2 percent, while Columbus taxable 4-percent bonds, due in 1956 and 1957, were offered at 2.75 percent—a spread of 0.75 percent.

Toledo tax-free 4-percent bonds, due in 1942, were offered at 2 percent, while Toledo taxable 4½-percent bonds, due in 1948, were offered at 2.80 percent, and those due in 1951 were offered at 3 percent and 3.10 percent.

These figures are from actual market offerings, and there is no guesswork about them. The only difference between the bonds issued prior to 1913 and tax-free and those issued since 1913 is the State intangible tax of 5 percent on the income. The quotations given here are all from cities that are legal issues in the East. The spread between tax-free and taxable in the smaller cities and school districts would be even wider. The exact comparison cannot be made between tax-free and taxable bonds in the various cities, because in order to be absolutely accurate the interest rate and the maturity date would have to be alike. The quotations given, however, are the nearest we can get to actual offerings of similar bonds. It is conservative to say that the spread is 0.75 percent. This average spread would be considerably larger if all the taxing districts in the State were taken into consideration.

The spread would be greater also in these cities were it not for the fact that many of these bonds are sold in other States where they are not subject to the Ohio intangible tax. The municipal debt of all Ohio subdivisions is around $700,000,000, and it might not be amiss to call attention to the fact that this is a reduction of $200,000,000 from 1931. The intangible tax of 5 percent on the income, therefore, caused an increase in local taxes of around $5,000,000 a year, but because of institutional holdings and because a large amount of these bonds were held outside the State, the intangible tax did not bring a return of an amount even approximating the increased taxes. Ohio would be better off financially if these bonds were not taxed at all, but perhaps the feeling of the people that the bondholders are obliged to pay taxes on bonds may be an adequate compensation.

It must certainly be evident that if the Federal Government taxes the income from State and municipal bonds it will increase interest rates substantially. A very conservative estimate would be that in Ohio it would add $4,000,000 to the tax bills, and whatever amount it adds would be that much deducted from the amount of revenue available for local services and schools.

If the financial structure of the Federal Government seems to require the discontinuance of tax-free bonds, either by the Federal Government or by State and local governments, then it follows that the Federal Government should retain the taxes on Federal bonds but that the taxes collected on State and municipal bonds should be

returned to the States in which the bonds were issued; otherwise, the only result of the whole scheme will be Federal taxes upon the taxes of municipalities which will further cripple local government and compel the people to be more and more dependent upon the Federal Government.

A few years ago a certain wealthy rural school district in Ohio issued $150,000 in bonds for a school building. These bonds were sold to a Michigan firm which was obliged to pay a tax of one-half of 1 percent once, and the bonds were then stamped, "tax paid," and were thereafter tax free. At the time of this sale these bonds were taxable in Ohio, but the only tax that was ever collected on them was $750 collected by Michigan, and that school district during the life of the bonds paid at least 1 percent more interest than was necessary had the bonds been tax free in Ohio or had there been a small tax but once as there was in Michigan. The only satisfaction the people of this school district received for this excess interest and tax rate was the thought that somewhere someone had to pay taxes on the bonds.

If a Federal tax is imposed on the income from municipal bonds, the few wealthy individuals and estates that invest largely in them will really not pay the tax. The tax is really paid by the real-property taxpayers of the municipalities issuing the bonds, and all that happens is that the wealthy holder gets more interest and pays some of it back in Federal taxes. Of course, all the small holders will escape the income tax, and therefore the municipality issuing the bonds would be the loser and the Federal Government would be only partially the gainer, even though the tax exactly equaled the increase in interest rates.

The interest rates will increase more than the amount necessary to pay the tax, because when an investor buys a long-term municipal bond, the interest rate is fixed during the life of the bond, while the tax rate may be changed by some, and therefore the investor must take this chance into consideration in bidding on the bonds.

I am well aware that Federal officials speak rather slightingly of the small increase in interest rates that will be caused by Federal taxation of municipal bonds, and guess at a 50-percent increase. But the process of governmental borrowing and paying higher interest rates and having part of the interest returned in the form of a tax is worse than futile, except for the slogan, "We soak the rich," when in reality it soaks the people who pay the interest and whatever of this excess interest is not collected in taxes is a loss to the Government. If an investor is willing to buy a bond bearing a certain rate of interest tax free and refuse to buy a taxable bond except at a rate of interest enough higher to pay the tax, the payment of the tax does not harm him in the slightest, because he has the value of the tax-free bond left after he pays the tax on the taxable bond. It harms no one under any circumstances in any way except the tax-payers of the district that issues the bonds.

In the report of the committee on debt adjustment of the Twentieth Century Fund two statements are made that are curious. One statement is that tax exemption of Federal, State, and local government securities "make it unhealthily easy for governmental bodies to go into debt." In the last 18 years, during which time we have purchased about $250,000,000 of Ohio bonds, we have failed to see any difference whatever in the amount of bonds issued due to higher or

lower interest rates. This past year a large number of bond issues were voted, but certainly not because the interest rate is low. The universal argument used in securing the passage of these bond issues was that the community would be obliged to help pay the bill for Federal grants and might as well secure whatever it could or it would go to some other locality. The way to make it "healthily difficult" for governmental bodies to go into debt is simple. Elect a Congress pledged to stop the increase in the Federal debt and make it very difficult to vote local bond issues. In Ohio a bond issue requires a 65 percent vote. This report continues with the assertion that this exemption also makes "debt investments too attractive to wealthy people who can best afford to run the risk of direct ownership in stocks, real estate, and other equities." By what method of reasoning does anyone conclude that making a safe investment unattractive will induce people or compel them "to run the risk of direct ownership in stocks, real estate, and other equities"?

If the committee please, the Ohio State teachers' retirement system holds in its portfolios over $85,000,000 of Ohio municipal bonds alone. If this proposal goes through, these bonds lose their constitutional immunity. They will be protected in such funds as our retirement system and in other fiduciary funds in the States and cities only on the sufferance of the Congress. The security positions of the municipalities themselves will be definitely weakened with consequent effect upon the stability of our holdings and with definite adverse effect upon the welfare of every teacher in Ohio who is employed by our municipal governments. It has been suggested that we might stand to gain by reason of the increased interest rate which new State and municipal securities will have to bear. For us to be swayed by such considerations would indeed be short-sighted. Even were it true, we would in effect be selling our birthright for a mess of pottage. We respectfully protest against the proposal and urge that this committee should not extend to it the sanction of its support.

The CHAIRMAN. Mr. Brush.

STATEMENT OF WILLIAM W. BRUSH, EDITOR, WATER WORKS ENGINEERING, FORMERLY CHIEF ENGINEER OF WATER SUPPLY DEPARTMENT, CITY OF NEW YORK

Mr. BRUSH. Mr. Chairman and gentlemen of the committee: Public water supply systems in the United States furnish water to about 80,000,000 people through the operation of approximately 11,000 water-supply systems that have cost to construct some $5,000,000,000. The payments made annually for the supply of water from these plants approximate $500,000,000.

Water systems are generally municipally owned. About 95 percent of the water consumers are served by public agencies, and practically all of the large cities of the country control their own water-supply systems. The only exception among the cities having a population of over 300,000 is Indianapolis, Ind., which is served by a private company.

Even though many small communities are receiving their water supply from private companies, the percentage of water plants that are municipally owned and operated falls between the 80- to 90-percent limits.

Waterworks construction undertaken during 1938 was very largely connected with publicly owned plants and amounted in round figures to $130,000,000.

The above figures give some idea of the magnitude of the water-supply industry and the extent to which it is a publicly owned and operated activity.

As the health, life, and protection of property, in every community of any size, are dependent upon the purity and adequacy of the water-supply system, there is a natural desire on the part of the citizens to exercise direct control over this essential governmental function, which was held to be such by the United States Supreme Court in the decision rendered on March 15, 1937.

Furthermore, water-supply systems generally represent very largely an investment in construction of a character that has a long life, usually 50 years or more, and can properly be financed by long-term bond issues which bear a low interest rate, especially when tax exempt. The amount that is expended for maintenance and operation, including the personnel employed, is relatively small. These conditions have all been important contributing factors towards ownership and operation of water-supply systems by the various municipalities.

It is obvious that the publicly owned water-supply systems are vitally concerned with any proposed taxation that would affect their personnel or the cost of securing money for capital expenditures. They would be even more vitally concerned with any proposal to tax their revenues, and, amazingly enough, I am informed that such an eventuality is within the scope of the legal arguments advanced in support of this proposal.

Between 1926 and March 1937 a Federal income tax on municipal-waterworks employees' salaries was demanded by various Internal Revenue Bureau collectors. There was no general demand made, so that, during this period, the total number of waterworks employees who paid a Federal income tax probably did not exceed two-thirds of those whose incomes would come within the taxable limits.

While the private water companies are not directly concerned, they are interested especially in the question of the taxation of the interest on municipal water bonds. The imposition of such a tax would bring the interest rate on municipal bonds more nearly up to the rate that the private water companies have to pay on their bonds, and thus make the financial picture in the waterworks field less favorable for the municipal ownership and operation of the water systems than has been the case heretofore.

Water supply is an essential governmental function. The Federal income tax on municipal waterworks employees' salaries was demanded by the Internal Revenue Bureau, based on the assumption that supplying water by the State or its political subdivisions was not the exercise of an essential governmental function. On March 15, 1937, the United States Supreme Court ruled, in the *Brush Federal Income Tax case*, that furnishing water supply was an essential governmental function. Following that decision, income-tax refunds were made by the Internal Revenue Bureau to those water-supply employees who had paid the tax on their salaries, and where the refund was not debarred by the statute of limitations.

Waterworks employees ask for uniform tax treatment. The municipal-water-supply employees claim that their salaries should be given the same tax treatment accorded to the salaries of all employees of

States and their political subdivisions and agencies who are also engaged in the exercise of essential governmental functions.

The interpretation of the United States Supreme Court decision in the *Gerhardt case*, as upholding the right of the Federal Government to tax all State salaries, including retroactive taxation back to the barrier raised by the internal-revenue law of 1926, greatly aroused the public-waterworks employees.

The American Water Works Association covers the United States and is the leading association in its field. Its board of directors has interpreted the views of the industry in the threat of retroactive income taxes in the resolution that was adopted at the annual meeting held in New York, January 18, 1939, a copy of this resolution being attached hereto.

It is believed that further comment on this phase of the income-tax situation is unnecessary on behalf of water works employees.

The proposal to include the interest on bonds or other certificates of indebtedness of the States and their political subdivisions as income subject to Federal taxation is of vital interest to the water supply industry. If this proposal be made effective, the cost to the water consumers will be increased, the undertaking of improvements and extensions of existing systems and the building of new systems will be delayed, and their number and extent will be lessened. The transfer to municipal ownership and operation of water systems now privately owned will also be materially retarded. These results would be caused by the increased cost of securing money for the construction of waterworks and for their extension.

Let us take as an illustration the water system of the city of New York. The construction of the vast water supply systems that are used to supply New York City represents an expenditure, in round figures, of $540,000,000.

The city, through its board of water supply, is now engaged in building the Delaware system, which will require expenditures in the next 6 years at the rate of nearly $40,000,000 annually. There must also be added the extensions and improvements to the existing systems, as carried out by the department of water supply, gas, and electricity, at an average of about $4,000,000 a year.

The bonded indebtedness on the existing New York water-supply system, as of December 31, 1937, amounted to $386,741,288, while the revenues for that year were $37,455,580.

The interest and sinking fund charges on the bonded indebtedness for the year 1937 amounted to $10,345,075, while the cost of operation and maintenance was $7,870,288.

It is to be noted that the annual expenditure for interest and sinking-fund charges on the bonded indebtedness is two and a half times the cost of operation and maintenance of the system. The effect of an increase in bond interest rates for the New York City system is, therefore, obvious.

For several decades prior to the onset of the recent great depression, it was usually assumed that the interest rate on New York City water bonds would average approximately 4.25 percent. The amortization charge for these bonds is taken as 0.8 percent, due to the bonds being issued on a 50-year maturity plan. The resultant total yearly charge for interest and amortization would be 5.05 percent. Assuming the interest on the New York bonds would rise 0.75 percent if the interest

was not tax exempt, then the cost of borrowing money for constructing the waterworks, including the amortization, would be 5.80 percent. This resultant cost of borrowing the money for constructing the waterworks would represent a rise of 15 percent.

On some $264,000,000 in bonds, which are anticipated to be issued within the next 6 years, the increase in interest would be about $2,000,000 yearly, which would be slightly more than 25 percent of the present cost of maintaining and operating the entire water supply system.

During 1938 the average interest rate on high-class municipal bonds was 2.9 percent. The estimated 0.75 percent increase in the interest rate, as a result of eliminating the tax-exempt feature of these bonds, represents an interest cost slightly in excess of 25 percent over the 1938 average figure. After adding in the amortization charge on the bonds on a 50-year basis, the higher interest rate would represent practically a 20-percent rise in the cost of securing money for constructing or purchasing water plants by municipalities.

The effect of this rise, in the slowing down of the construction of plants and acquirement of private plants by municipalities, is obvious. The present low interest rate on municipal bonds has been one of the important factors in the noticeable increase in the number of private water company plants that have been purchased by the municipalities in recent years.

I submit a resolution of the American Water Works Association, which I shall not take time to read, but ask that it be incorporated in the record.

The CHAIRMAN. It will be received.

(The resolution referred to is as follows:)

AMERICAN WATER WORKS ASSOCIATION RESOLUTION AGAINST RETROACTIVE TAXATION OF MUNICIPAL WATER WORKS EMPLOYEES' SALARIES

Whereas recent judicial decisions relative to the liability of employees of the States and their civil subdivisions for Federal taxation of their income have been interpreted to authorize the Internal Revenue Department to enforce a collection of such taxes not alone for the 1938 period but also retroactively for the entire period of years for which there may be legal liability under existing laws as now interpreted,

Whereas many of the members of the American Water Works Association who are employees of States or their political subdivisions have been led by the tenor of previous judicial decisions to consider themselves not liable for Federal income tax, and in good faith have so acted; and

Whereas it has reported that, in a very recent press conference, the President of the United States has indicated that he would recommend that legislation be enacted to remove the possibility of retroactive taxation of such persons; therefore be it

Resolved by the Board of Directors of the American Water Works Association in annual meeting assembled in New York on January 18, 1939, That it approve and heartily support the recommendation that the Congress enact such legislation as will relieve State and municipal employees from the possibility of retroactive Federal income taxation.

AMERICAN WATER WORKS ASSOCIATION RESOLUTION—TAXATION OF INTEREST ON MUNICIPAL BONDS UNLESS AUTHORIZED BY CONSTITUTIONAL AMENDMENT

Whereas the Federal Department of Justice has advised the Treasury Department, "that the principle of immunity protected the Federal Government against taxation by the States, but did not necessarily shield the States against the exercise of the delegated and supreme taxing power of the Central Government;" and

Whereas the enforcement of this opinion would affect the States and their political subdivisions by taxation of the interest paid on their bonds and other certificates of indebtedness; and

Whereas the financial situation of the water-supply systems that are under the control of municipalities or other political subdivisions of the State would be vitally affected by the Federal Government's taxing the interest upon the securities of such systems; and

Whereas it would manifestly be unfair to the present owners of municipal water bonds to be taxed on the income derived from such bonds, when the bonds were sold on the basis that such income was legally tax exempt; therefore be it

Resolved by the Board of Directors of the American Water Works Association at the annual meeting assembled in New York on January 18, 1939, That it oppose any Federal taxation of already issued water-supply or other securities of the States, their subdivisions and agencies; and that the right of the Federal Government to tax future issues of securities of the States, their subdivisions and agencies, should only be granted if the consent of the States is first secured through the adoption of a constitutional amendment that would guarantee the reciprocal right of each State to tax future issues of Federal securities as they may be held within the various States.

The CHAIRMAN. I have a telegram from Mr. Henry F. Long, Commissioner of Corporations and Taxation, of the State of Massachusetts. He has stated that he cannot be here to testify and his telegram will be made a part of this record.

(The telegram referred to is as follows:)

BOSTON, MASS., *February 8, 1939.*

Hon. PRENTISS M. BROWN,
United States Senate, Senate Office Building,
Senate Finance Committee Hearing Room.

Important matters which I cannot postpone have arisen in Massachusetts preventing my being in Washington today. In the event it would have been my privilege to have availed myself of your kindly courtesy I could have suggested for consideration of your committee that Massachusetts and I think all of New England would be very unfavorably affected by your committee favorably considering the proposal before you. The obligation to pay higher rates of interest for money borrowed would seriously affect our governmental units. The result would not in my opinion even though some additional revenue might come to the Federal Government warrant what in fact is an assessment by the Federal Government upon Massachusetts and its political subdivisions. The exemption from taxation of borrowings for governmental purposes is traditional with us here n Massachusetts because as early as 1690 the Colony of Massachusetts issued £7,000 of bills of credit which was soon increased to £40,000 in order to pay the soldiers engaged in the expedition against Port Royal and Quebec in the French War. The public treasury was empty and the soldiers would not or could not wait for a levy of taxes. There began the practice of issuing securities which, in order to encourage immediate purchase were issued free of tax: the Colony and the Commonwealth since having always felt that the tax was in fact paid at the time the money was made available by agreeing to accept a lower rate of interest for all loans. Massachusetts has made its own State bonds expressly exempt since the passage of chapter 493 of the acts of 1906. City, town, and district bonds have been expressly exempt since the passage of chapters 464 and 594 of 1908. We have in Massachusetts adequate funds to hold all of our municipal indebtedness and that means that on those funds which are tax exempt we do obtain a much better rate of interest than we probably could obtain were they taxable. The passage of such an act as is proposed and which you are considering would have a very serious effect upon Massachusetts and all of New England. For the Federal Government to thus indirectly tax the States and their political subdivisions would be not only unfair but would have a serious effect on those States that have tried to live thriftily and efficiently.

HENRY F. LONG,
Commissioner of Corporations and Taxation.

The CHAIRMAN. The committee will now recess until 10 o'clock tomorrow morning.

(Thereupon, at 4:30 p. m., a recess was taken until 10 a. m. the next day, Thursday, February 9, 1939.)

TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

THURSDAY FEBRUARY 9, 1939

UNITED STATES SENATE,
SPECIAL COMMITTEE ON THE TAXATION OF
GOVERNMENTAL SECURITIES AND SALARIES,
Washington, D. C.

The special committee met, pursuant to recess at 10 a. m., in the committee room of the Senate Finance Committee, Senate Office Building, Senator Prentiss M. Brown, chairman, presiding.

The CHAIRMAN. The committee will come to order.

All right, Mr. Riley, we will hear from you.

STATEMENT OF GEORGE D. RILEY, EDITOR OF "U. S. AND US," WASHINGTON TIMES-HERALD

Mr. RILEY. Mr. Chairman and gentlemen of the committee: I appreciate the fact that the House is about to take up legislation based on the lines that you have here for discussion, and I appreciate the fact that you are breaking your train of thought in the investment end to permit me to appear here today.

The CHAIRMAN. I am very glad to hear some testimony on the salary question for as yet we have had little on that proposition.

Mr. RILEY. It is my desire as an interested citizen to offer for your consideration a few points that I believe may otherwise fail to be brought to your attention in dealing with the subject of reciprocal taxation of the salaries of Federal and local government employees.

The first point that I should like to make is that it has long seemed clear to me that there has been an inspired campaign to convince the public that Federal employees pay no income tax. A representation to this end is quoted from an official of the Treasury Department who must himself know better. I wonder why such an unrestrained statement could have been made. I quote:

> * * * there is no single item which so irritates the taxpayer of modest means as the statutory exemption of Government * * * employees from the income tax.

That statement and others of like vein have been made by the chief counsel of the Bureau of Internal Revenue, John P. Wenchel. I assume Mr. Wenchel pays income tax himself, although his statement, made before your committee clearly indicates that he desires to have it understood that no one employed by the Government pays such a levy.

You, yourselves, as United States Senators, pay income taxes. No one who draws a salary check from the United States is excluded

from the payment of tax to the Federal Government, if he earns enough money, aside from a few statutory exemptions.

The CHAIRMAN. Everyone in Congress knows that he pays an income tax.

Mr. RILEY. I assume that Mr. Wenchel pays income tax, yet, in his statement before your committee he drew the inference that no one who serves his Government pays income tax.

Since the inception of the income tax a quick calculation reveals the fact that not less than a quarter of a billion dollars has been paid into the Federal Treasury over the counter in Mr. Wenchel's own Bureau of Internal Revenue—in income taxes by the Federal employee. The amount is increasing every year, and will be reaching new highs in numbers of employees and total tax paid each year, due to the recent increase in average pay, particularly in the newer agencies of Government.

Senator TOWNSEND. Would it bother you too much if I asked you a question?

Mr. RILEY. Not at all.

Senator TOWNSEND. Is there any definite knowledge, or do you have have any knowledge, of the amount of income tax that the Government officials pay?

Mr. RILEY. I have bulked it there, and made a rough figure—about a quarter of a billion dollars since the income-tax law was passed. That has been paid by those in the public Federal service. Taking the average salaries, year by year, they are around the $1,500 figure, and that is the basis I arrived at, and it was, conservatively, a quarter of a billion dollars.

Senator TOWNSEND. What percent of the Government officials' salaries exceeded $1,500?

Mr. RILEY. We have salaries that would run higher today, due to the fact that we have a lot of new agencies, and it will run about $2,000 in those agencies. It will run, I would say, around $1,700. They are subject to the same exemptions.

The CHAIRMAN. You have in mind, of course—you mentioned some statutory exemptions, and, of course, you have in mind the condition with respect to judges, that judges are exempt?

Mr. RILEY. Yes, sir; that is correct.

The CHAIRMAN. Except those that have been appointed since 1933?

Mr. RILEY. Yes, sir. And from now on they are subject to taxes. I should like further to make the point that the Federal employee, of all people, has perhaps the least chance of dodging the income tax he already is eligible to pay, for the Government not only pays him, but is also the collecting agency and maintains a complete record of its own employees' salary receipts, which, of course, must tally with what the employee says he got in income in the taxable period.

It is not my purpose to discuss the legal aspects of the proposal. It seems to me that a prime purpose is to prepare all citizens for the onrush of new and heavier taxation by holding the Federal employee up as a tax dodger, and as the pariah for all self-respecting persons to shun. Potshots at the Federal employee have been taken for years just for sport. The Federal employee has had to take it in silence, for at times his own employer, the United States Government, has seen fit, through its officials, to make such attacks itself and to permit other attacks of misrepresentation to continue and to swell.

In recent years, you gentlemen have perhaps come to know personally more men and women who work for the Federal Government than at any time before. Therefore, perhaps you know that there are some who, when called upon to declare their legal residence for voting purposes, will elect to surrender their franchise in the States, knowing that plans are also in store to clap on an income tax in the District of Columbia. There being no franchise in the District, such new forms of income taxation may easily constitute a penalty on citizenship, which seems to run crosswise to the present agitation for abolishing poll taxes.

The CHAIRMAN. As to Virginia and Maryland, do they have income taxes?

Mr. RILEY. Yes. My understanding is that they have.

The CHAIRMAN. What I was getting at is, a Government employee who lived in Alexandria pays both State and Federal income taxes?

Mr. RILEY. Yes, sir; and as we go along I will call your attention to the fact as to tangible and intangible properties that will be gradually picked up and converted into income tax by even local governments such as counties and cities.

The CHAIRMAN. I mean, of course, if the proposal of the President went into effect, he would pay both Federal and State taxes?

Mr. RILEY. I will bring out more fully regarding the income taxes for persons who live in the District.

Chief Justice Marshall reminded us that——

> If the right to impose a tax exists, it is a right which in its nature acknowledges no limits. It may be carried to any extent within the jurisdiction of the State or corporation which imposes it, which the will of each State and corporation may prescribe.

Now, if it be the desire of Congress to open the sluice gates for the overflow of taxation to inundate the lowlands of national income, first by pointing derisively to the Federal employee as a tax dodger in order to retain a united front among the rest of the population, then the way is indicated through reciprocal income taxes. But having first pounced on this artful tax dodger, "misery loves company" becomes an apt expression, for surely new taxes will overtake the entire citizenry, once the Federal employee is put in his place. And as Chief Justice Marshall sagely observed, the sky is the limit, not alone for Federal and State employees, but for all persons.

Thus it has been evident that the public servant has played the role of the little Dutch boy by holding a finger in the dike against swollen waters of newer and heavier taxes. When the irresistible waters of heavy spending dash headlong into the waters of immovable taxation, you members of the committee can tell better than I at what point a level will be reached.

I would ask by what means Congress expects to enact legislation to authorize a tax by a State. It seems only remotely feasible for Congress to authorize a State to do anything that the Constitution does not already permit. If it be then constitutional for a State to perform an act at present, no legislation is indicated. I need not tell you committeemen that the courts have held rather consistently that the States are without such power and that, therefore, Congress cannot grant such prerogatives. The sixteenth amendment does authorize the Federal Government to collect taxes "from whatever source," but where in that amendment is found permission for a State to tax incomes otherwise precluded from taxation?

Senator TOWNSEND. I take it, if the tax were to be levied at all, you would feel that it should be by a constitutional amendment?

Mr. RILEY. A constitutional amendment is the procedure I have indicated here.

The Federal Government can tax to its collective heart's delight any and all incomes, except as noted by the courts and the statutes but where in the amendment is found reference to a State's being granted the same right?

Yet, that step is exactly what is proposed in the legislation demanded of you Senators.

Further illustrating Justice Marshall's vision, I ask you to consider the situation a Federal employee in Washington might find himself in, once you undertake to do what the courts have forbidden. A man voting in New York might reside in Virginia or Maryland while earning his living in the District of Columbia. When the new fashion of reciprocal income taxation is adopted, I have no trouble in seeing such a person taxed first by the Federal Government, second by the District of Columbia government, third by Maryland or Virginia where he actually lives, and fourth by New York State, where he does his voting and which he claim[illegible]his home.

As a specific example of w[illegible]t is meant by opening the floodgates to newer and heavier taxation, I call your attention to the fact that only this month the Board of Tax Appeals has ruled that Government employees claiming residence elsewhere must pay taxes in Washington on intangible personal property. In that ruling it was held by Jo V. Morgan that--

such persons are domiciled in the District and not in States wherein they claim "legal residence" and therefore are subject to tax.

The case was one in which an attorney of the Department of Justice failed to pay on assets held in a Baltimore bank.

For purposes of the record, I have attached the pertinent paragraph to this copy, which is handed to the secretary.

Declaration of intention to reside in a State and the fact of voting therein lose most if not all of their import when determining whether an employee of the Government domiciled in the District, when it is considered that a great many employees of the Government, who have made their home in Washington for many years and intend to remain here for the rest of their lives, or at least indefinitely, carry into practice a widespread belief that it is convenient to maintain in one of the States what is commonly called a "legal residence" wherein they register and vote in elections, and adopt residential addresses, for the purpose of improving their status as a Government employee in relation to State quotas and preferment in Federal employment, and of supplying an apparent basis to support claims or calls upon Members of Congress and politicians for assistance and backing in the employee's plans for advancement in Government service.

If this fashion of universal tax liability receives the stamp of approval of the Senate, we may expect cities and counties also to shift from the basis of taxation of personal property to a basis of taxation on incomes. At that point we may expect that the high glee of pasting the artful dodger, the Federal employee, suddenly will turn to chagrin, for it will dawn on the entire population that after all the taxation was meant for them and that the Federal employee was but the instrument through which the Federal Government has intended from the first to reach everyone.

When the District of Columbia adopts an income-tax law, basis for exclusion doubtless will be proof that the exempt is a resident and

voter elsewhere. How, then, can we blame Ohio or North Dakota, or New York, or Colorado, if one of these or some other State exacts proof that one is not a citizen? Thus, many will become fugitives from the franchise and taxes will be claimed by a number of taxing jurisdictions.

The case of *Collector* v. *Day* was decided—

at a time when the court was concerned with the continued existence of the States as Government entities, and their preservation from destruction by the national taxing power.

This was a case in which the court denied the Federal Government's right to tax the income of a State employee.

Today, however, we may take it that no such danger exists, since in *Helvering* v. *Gerhardt*—Mr. Justice Black for the majority—it was held that—"the entire subject of intergovernmental tax immunity should be reviewed," and the right to tax granted. But, if we do take it so, we take it amiss, for to the more than casual observer, it becomes apparent that the entire trend today is toward the erasure of State lines, toward the abolition of parochialism and local patriotism. Perhaps you will pardon the reference to 1938 in which year frequent mention was made of purges and, as frequently, the rejoinders had to do with local self-government, and self-determination.

Federal Government is being spread more heavily across the States than ever before. Another exemplification of that fact is seen in the expressed determination of some to accomplish this end, one means being the universal employment of eligibility registers in selecting public employees for Federal, State, county and municipal government. You who pay taxes at home probably see new faces at the collectors' windows. The reason for it is simple. It is fashionable today for New York to send students as apprentices and internes, financed by money supplied by the Rockefellers and by others to States far from their homes where it is the intention that local patriotism be broken down by giving public jobs to those from other States.

California today has men in public offices who originated in Washington. Michigan is employing men who got their training in the Brownlow gadget organizations in Chicago, and Washington has internes who are permitted to range the offices in learning what makes the wheels go around, so they may qualify for good public service jobs elsewhere. It has even been insisted that these privileged internes be given preference, as is given to war veterans.

If I have seemed to digress it has been because I have felt that this idea of reciprocal taxation is but one of a string of ideas that tend toward more and more Federal power centralization.

These Brownlow organizations to which I have referred appear to be the fountainhead of many of these ideas. Regardless of what kind of expert opinion any level of government desires, a Brownlow organization leaps to the fore with just the right idea and just the right man, of course, as the result of a group of studies they have just completed.

Recently we have seen discussion, not to say agitation, to tamper with the Federal employee retirement basis. The civil service has been booted about, starved, and then found wanting.

These are but a few highlights among the trends that have occurred in the past few years, and which are now occurring with accelerating

frequency. And all of this is, I believe, in order that organized groups may fence off for themselves the opportunities for employment that exist in the public service I honestly believe that at an early date raids will be made on the membership of the House and of the Senate, and that some organizations, which have been advocating "merit" as measured by book learning as the basis for public employment, will dare to try to place similar restrictions upon candidacy for such office as is held by you committeemen.

This idea of reciprocal taxation is not new. I saw it coming more than a year ago, and on December 10, 1937, published in the Washington Herald a prediction of the present reciprocal tax proposal. I tell you this, not in self-adulation, but in substantiation of the fact that he who observes may note the trends.

The proponents of this type of legislation are organized. They meet together and plan. The opposition is not organized. It does not know that such legislation is on the agenda. It will awake some morning to find itself liable to new forms of taxes that will hurt. It does not now know that it is in opposition.

The people expect their Senators and Representatives in Congress to defend them against all forms of minor encroachment that will in the end add up to a condition that requires difficult remedy. Therefore, it is respectfully suggested that 42 legislatures are now in session and that formal or informal communication with the leaders of those bodies would result in information concerning the attitude of the States—who stand to pay far more into the Federal Treasury than they would be getting under this plan. I would have you gentlemen consider that there are approximately 5,000,000 public employees in this country. Only a little more than three-quarters of a million of these are employed by the Federal Government.

The amount that would thus be drawn from the States is vastly in excess of the amount the States could secure from tax on Federal employees, who work in the States.

Thus, in fairness to the legislatures which represent the people of the States, this end should be placed before them and their opinions solicited.

Mayor LaGuardia, of New York City, and other important State and municipal officials, who have testified before your committee, have spoken in opposition to this question of reciprocal taxation. It is respectfully submitted that in deference to their knowledge, the entire question should be handled as a constitutional amendment, or at least only after the legislatures of the several States have indicated their views.

In closing, let me make the point that reciprocal income levies are nothing short of taxing taxes. When Tennessee decides to tax income derived from taxes collected from all the other 47 States, as well, and paid into the National Treasury, who will be the first to say that the other 47 States may not do likewise?

No State will acknowledge the sovereignty of other States beyond their borders. Who, then, will be the first to say that the States are not each and every one perfectly within their rights should they decide to levy taxes on public lands bought with moneys collected from 48 States?

The United States Government owns more than three-quarters of a billion acres of public domain, and post offices, arsenals, custom-

houses, fortifications, army posts and navy yards are scattered widely throughout the country.

And, if Federal lands and other property can be taxed by States, what prevents the taxation of standing timber above the ground and minerals yet unmined below it—all in the name of reciprocal taxation? After all, the Constitution does say, "from whatever source."

The point I am trying to make is, the Federal lands and other properties can be taxed by States, so what is there to prevent the taxing of standing timber on the ground, and minerals under the ground, for, as I say, the Constitution does say, "from whatever source."

The CHAIRMAN. As I pointed out yesterday, in the State of Michigan, the State pays 10 cents an acre on all State lands, forest lands, and so on; not on State buildings, but on the timber lands and the swamp lands in the various counties of Michigan. That is paid to the county government, and I know that Senator Schwartz has a bill, and, as I understand it, several other Senators, proposing that the Federal Government be required to pay something toward the local governments.

Thank you very much, Mr. Riley. That was an illuminating discussion on a matter that has not been brought to our attention as yet.

The committee will recess now until tomorrow morning at 10 o'clock.

(Thereupon at 10:40 a. m., the special committee recessed to meet again at 10 a. m., the following day, Friday, February 10, 1939.)

TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

FRIDAY, FEBRUARY 10, 1939

UNITED STATES SENATE,
SPECIAL COMMITTEE ON THE TAXATION OF
GOVERNMENTAL SECURITIES AND SALARIES,
Washington, D. C.

The special committee met, pursuant to recess, at 10 a. m., in the committee room of the Senate Finance Committee, Senate Office Building, Senator Prentiss M. Brown, chairman, presiding.

The CHAIRMAN. The committee will please come to order.

We will now hear from Mr. Carl H. Chatters, the executive director of the Municipal Finance Officers Association.

As I understand, Mr. Chatters is the concluding witness.

Mr. TOBIN. Mr. Chatters is the concluding witness on the economic and fiscal side of our case.

STATEMENT OF CARL H. CHATTERS, EXECUTIVE DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. CHATTERS. Gentlemen of the committee, since 1922, I have been interested in municipal affairs as director of finance of Flint, Mich., for 9 years, and, later, representing all of the interests in the Detroit area, trying to work out the defaults there, and, since 1932, as fiscal director of the United States Association of United States and Canada, and, in addition, I have been working with both the Federal and State Governments relating to finances, particularly to the refunding of debt and other financial matters.

Your committee is considering the proposals to tax the salaries of public employees and the income from State and municipal bonds. The broader question you consider is the removal of certain tax exemptions now accorded the employees or the debt obligations of the Federal, State, and local governments. The proposals before you do have the questionable advantage of appearing, on their face, as steps toward greater equity in the impact of public burdens. But to those concerned with State and local finance there appears little equity in proposals which increase the cost of local government with few, if any, compensating advantages. Likewise, there seems little equity in proposals which would impose added burdens locally, upset the traditions of 150 years, necessitate numerous adjustments and yet accomplish little in the way of increased revenues or a fairer distribution of the public burden. Removal of State and local exemptions, in my opinion, will cause far more iniquities than it will remedy,

The salaries of State and local officials are now exempt from the Federal income tax and the salaries of Federal employees are exempt from taxation by the States. I do not care to defend this exemption, provided any new tax measures affecting such salaries apply to future income only, and, provided further, that State governments which have an income tax are given reciprocal rights to tax the income of Federl employees located within their jurisdiction. One other danger exists, namely, that the taxation of salaries might be used as an entering wedge to tax the income of public and quasi-public corporations.

Now, I am concerned with the legal aspects of the present proposals. Either it is right and necessary for you to subject State and local bond interest to Federal taxation, or it is wrong to levy such new taxes. The new taxes, if levied, will be just as great a burden, and will cause the same transfer of burdens, whether you resort to statutory measures or invoke a constitutional amendment. The city of Detroit, for instance, will find the same difficulties obstructing its refunding program, whether interest rates on local securities are increased by statutory or constitutional changes. Even if it be conceded that the sixteenth amendment gives the Congress the right to tax the income from State and municipal securities, still, it should not be done.

Increased interest costs to States and municipalities will surely follow Federal taxation of their securities. The rates will be increased from 0.25 percent to 0.60 percent per annum on medium and long-term bonds. Treasury officials and other experts generally agree that interest costs will rise and estimates of the increase do not vary greatly between the Treasury experts and others.

The increased cost of local borrowing would be borne by local taxpayers and would be reflected directly in one spot; namely, the local real-estate tax. This added burden to local government, no matter how small it may be, comes at a time when cities are being hamstrung by tax limitation and homestead exemption laws and at a time when local governments are burdened by the costs of direct relief and the matching of Federal funds for various Federal programs. Since your committee is considering the elimination of undesirable exemptions in the interests of greater equity, your attention may properly be directed to the increased volume of tax-exempt properties in cities throughout the United States imposed or encouraged by the United States Housing Act. Should the Federal Housing program become widely accepted, the amount of housing exemptions would increase to the point where eventually they would be unfair to all concerned.

You are considering the elimination of the tax-exempt privilege in public securities. Special attention might be given to the Federal debt and the possibility of eliminating the tax-exemption privilege it enjoys. As a matter of fact, the total-exempt local debt in the hands of potential taxpayers is such a relatively small proportion of the total tax-exempt debt that consideration, if desirable, might better be given to eliminating the exemption privilege on Federal bonds, which can be done by statute, leaving alone the present status of municipal bonds.

One hundred and twenty-five cities over 5,000 population in the United States are still in default on their bonds. They are still attempting to rearrange their debt maturities through the refunding of their bonds. Should future issues of municipal bonds be subject to taxation, it will make it extremely difficult and far more costly for these 125 municipalities to refund or readjust their debts.

You have heard how Detroit will suffer a direct loss of many millions in interest during the next few years should you tax municipal-bond interest. Some of the States, including Arkansas and Texas, may also wish to carry on extensive refunding with like results. The Congress, at an earlier session, adopted amendments to the Bankruptcy Act so that public bodies in serious trouble might, with the consent of their creditors and the courts, make orderly readjustments of their debts. The future taxation of new issues of bonds would make refunding impossible or unprofitable for the public bodies still in default and least able to make satisfactory refunding arrangements. The drainage, levee, and irrigation district debts which the Reconstruction Finance Corporation has assisted in scaling and refinancing would be directly concerned.

Examine carefully the transfers of tax burdens that will take place should you tax the income on local government bonds. Several steps are involved:

(1) Some present group of Federal income taxpayers, now enjoying the exemption privilege, will be required to pay greater taxes to the extent that tax exempt securities are not available at advantageous prices. That alone would be desirable.

(2) A much larger group of Federal income taxpayers will have their burdens somewhat lightened, because the present burden will be spread over a larger group of taxpayers. Of course, if the new revenues are used for new expenditures, even this second group, the only one to benefit at all, will receive little, if any, benefit.

(3) The added cost of bond interest to the State and local governments, which, according to the Treasury's and other estimates, will be somewhat proportionate to the increased revenues, would be saddled quite largely on a group different from groups one and two; namely, on the local real-estate taxpayer.

(4) The present holders of tax-exempt bonds who own securities for purposes other than tax exemption would be unjustly enriched should Congress tax future bond issues now exempt. This follows because of the demand that would ensue for exempt securities, the decrease in volume of such securities, and the increase in price which present holders could realize.

Now, considering all of these adjustments and all of these transfers of burdens, is the proposal worth while, or does it bring any greater degree of equity than now exists?

Returning, for a moment, to the transfer of taxation from one group to another, the Treasury has suggested, although with some reserve, that even the local governments might get some reciprocal benefit from State income taxation of Federal bonds. But you should know that in only 13 States is any part of the income tax returned to the localities and in 6 of these it goes directly for schools. The 13 States in which some part of the income tax goes back to the localities are Iowa, Louisiana, Massachusetts, Minnesota, Missouri, Montana, New Hampshire, New Mexico, New York, Oklahoma, South Carolina, Tennessee, and Wisconsin.

Past experience demonstrates only too well that the States and the Federal Government do not often or gladly give back to the localities any taxes which the States and the Federal Government collect. Their collection of a tax gives them a proprietary right to it.

The Federal taxation of local government bonds involves too many readjustments to make it worth while or desirable. At the most critical time in their financial history, local governments would have to readjust their whole experience of borrowing and go along on uncharted seas.

Furthermore, the effects of the reciprocal taxation, if it is granted, will be enjoyed unevenly among the States. The States with accumulated wealth and with a heavy accumulation of taxpayers in the higher brackets will profit more than the poorer States where the residents will own few, if any, Federal bonds to be taxed by the States.

The Social Security reserve also enters into the discussion. To the extent that the $47,000,000,000 reserve is retained, it will benefit by the future taxation of Federal, State, and local bonds. Since the interest rates on State, local, and Federal bonds will be higher, the Government will therefore get a greater return on the Social Security reserve through paying to itself, from money raised by taxation, a higher rate of interest on the bonds held in the reserve.

Furthermore, if the Federal debt is brought into the Social Security reserve, it would not be taxable by the States and, therefore, the reciprocal taxation of bonds by the Federal Government and the States would be meaningless.

Another readjustment to be seriously considered by the Treasury will be the effect on the vast holdings of Government bonds in the banks of the United States. The decline in the price of these holdings would seriously impair the capital of nearly all banks. Just what the taxation of the income from future bonds and the resulting increased interest rates would do, is not clear.

The CHAIRMAN. We have discussed the proposition of making an exemption of refunding bonds, if it could be done with safety. That is on the assumption that something would be done. I do not know whether you are aware of that or not.

Mr. CHATTERS. I have not been at the hearings, and have not read the testimony.

The CHAIRMAN. There is probably some justification to the view that refunding bonds should be exempted.

Mr. CHATTERS. It would seriously impair the refunding program.

Senator AUSTIN. Is there, in your opinion, a reasonable basis for classifying that, for classifying them in a special class?

Mr. CHATTERS. By that you mean classifying the future issues of bonds in a special class?

Senator AUSTIN. The refunding bonds.

Mr. CHATTERS. It is not very plain to me what you want to classify, Senator. I would like to answer the question, but I would like to know what you want me to classify.

Mr. TOBIN. Mr. Chatters is not a lawyer, may it please the committee.

Senator AUSTIN. I understand.

The CHAIRMAN. Would it be fair to separate the refunding bonds from the new bonds for any reason whatsoever?

Mr. CHATTERS. If the taxes were to be levied on future issues of municipal bonds, it would be feasible and possible to separate the refunding bonds from new issues, but, in my opinion, if you made a differentiation of refunding bonds, it would be impossible to make such a differentiation which would always and at all times accomplish

what you would want to accomplish. In other words, if you made it too tight, if would destroy the effect of it, and if it were made too loose, the city could use it for the purpose of evading the law.

Of course, the banks would probably have a higher rate of earnings on future local bond purchases, but, again, the local real estate taxpayer would be contributing to pay the higher rate of interest earned by the banks' depositors.

More important than the fiscal or economic effects of the proposed change is the political aspect. The taxation of State and local salaries and State and local bonds by the Federal Government further centralizes governmental revenues and, therefore, the authority of the Federal Government, with a consequent weakening of the fiscal powers of the local governments. Right at this time the existence of democracy is an issue. In some quarters it is the chief question before the people. Now, a democracy exists only on a basis of strong, virile local units of government, such as we have in the United States, France, and Great Britain.

At the moment the chief issue before local governments is this simple problem: Is it possible to bring into balance the demand for local services and the financial resources available to carry them out, and do so within the present framework of democratic local self-government?

The only possible group that can be benefited is that group of Federal income taxpayers who would have their burden slightly lightened should the present tax burden be spread over another group, and that is the only group of taxpayers who would in any way benefit. You would wipe out, on the one hand, the inequality that now exists, and benefit only in a slight degree the group of Federal taxpayers who would have their taxes lightened, for it would be spread over a greater group.

Then, at this point, it seems to me that Mr. Hanes made the statement that should be challenged, for it seems to bear on the point. Mr. Hanes said:

> To attempt to break the taxpayer into pieces and to set his interests as a State or local taxpayer against his interests as a Federal taxpayer gives a false impression of his total position. Even if the majority of taxpayers were obliged to pay slightly more than they now do in taxes to State and local jurisdictions to defray added costs, this would be more than offset by a reduction in Federal taxes because of the additional amounts paid by taxpayers with high incomes now benefiting from tax exemption.

The CHAIRMAN. What page are you reading from?

Mr. CHATTERS. I am reading from page 12 of the hearings.

Mr. Hanes said, earlier in that paragraph:

> All of our citizens are taxpayers directly or indirectly to all three types of government.

Now we propose to further burden and emasculate the local governments and make them less a proving ground for democracy by doing to them two things: First, increasing their financial burdens; and, second, concentrating revenues in the Federal Government. Even if the proposed taxation involved no fiscal effects—which it does—and even if the proposed taxation involved no economic adjustments—which it does—still, the proposal to tax the income from State and local bonds should be abandoned because of its effect on our political structure and the further centralization of authority.

The proposal to tax the income from State and local securities ought to be abandoned because:

(1) Increased interest costs would be imposed on State and local governments without any compensating advantage to the local governments.

(2) Refunding plans contemplated, or in progress, or financially sound, would be rendered impossible or unprofitable for cities, counties, and special levee, irrigation, and drainage districts.

(3) Removal of the exemption would impose added burdens on some, grant unjust enrichment to others, and redistribute only a minor part of present Federal taxes.

(4) The States and localities would face new financing problems at a time when they are confronting many other uncertainties because of relief burdens, restrictive revenue laws, and added social responsibilities.

(5) Reciprocal rights of taxation of bonds by Federal, State, and local governments would be of little advantage to the latter, and, through operations of the social security reserve, might be of little benefit to the various States.

(6) Finally, since the preservation of democratic government depends on the continued existence of virile units of local government, their existence should not be threatened by one more measure to deprive them of the means of existence.

Removal of the tax-exempt status of State and local bonds has only the doubtful argument of greater equity in its favor. Opposed to it are all the fiscal, economic, and political arguments cited.

I wish to emphasize this, Mr. Chairman, that I think it is only fair to say that, in my opinion, only a relatively small part of the holders of municipal bonds buy them primarily or solely for the tax-exempt privilege.

We have the impression, from the statements we read in the newspapers, and statements which have been loosely made, that everybody that buys tax exempt bonds buys them because of the tax exempt privilege. I do not think that is so. That, the distribution of the holdings will show, is not the case, and this is a popular misconception, which should be made clear in the record.

There is another argument brought forth in several places that should be cleared up. It seems that it should hardly be cleared up; but I think it should, and that is the statement that the present exemption, by causing a low yield, prevents the owners of the bonds and investors from getting as large a yield as they otherwise would.

In answer, I wish to say that the Government and municipalities and the States do not sell bonds to give somebody a high yield, but they sell them for some other purpose, and they want to get the lowest possible rate. You sell securities to get money at the lowest possible rate, and not to give somebody a return.

The CHAIRMAN. On the proposition that you advanced, I made inquiry the other day of a very large and prominent organization who advise in respect to such things, and they tell me that they think there would not be any particular rise in the price and market value of outstanding municipal bonds which would be affected by the statute. They say that, while the yield is not extremely low, yet, we are on a low yield market, and they look for no rise in price.

I had the same idea as you did.

Mr. CHATTERS. Might I say that late in September I talked with the financial secretary of one of the largest life insurance companies in the United States, and he told me that they would welcome the removal of exemption, for that would increase the yield, and they needed the increase in price, and he further stated that they would unload the securities they now held, as they went up, and buy others.

The CHAIRMAN. It is a matter of guesswork, after all.

Mr. CHATTERS. It seems to me that, as the volume of bonds became less, the demand would become greater, and, therefore, in spite of the present low yield, the tendency would be for the price to go up, for all of the bonds do not have the low yield, and the only market would be in this group of 12,790 taxpayers who, the experts say, would have the advantage in their tax payments by reason of the ownership of these bonds.

The CHAIRMAN. That is a very limited market.

Mr. CHATTERS. I think that is right, but the burden would be increasing every year, as these bonds matured, and there would be a scramble for the bonds outstanding.

There has been one other question that has been brought up from time to time before the committee, and that is, whether or not the present low interest rate encourages spending and extravagance on the part of local governments, and I understand that the committee has had discussions before it on that point. As to that, in my opinion, I wish to state that if we were to raise the interest rates I do not think that it would in any way tend to reduce the amount of borrowings or reduce the reckless spending that has been talked of—for this reason:

I think that those who do the reckless spending are those who are paying the high rate of interest, and it not the low rate that encourages the spending, and the higher rate goes to those who have been doing the spending, and it goes to those who do the best job that they can, and their bonds are in a better class. There is also this fact, that those who are paying the high rate are doing so due to the geographical location, and, therefore, it is not fair to say that you are going to decrease spending by increasing the rate of interest. It hardly seems to follow.

The CHAIRMAN. I wish for the moment to discuss briefly the question of the proportion of return to the Federal Government and the State governments, based upon the present condition and the present income-tax laws of the States. It is rather hard for me, looking at the situation in a large way, to understand that where the Federal Government subjects $40,000,000,000 of securities to State taxation, and only asks that the States subject $16,000,000,000 to Federal taxation, to see how the States will lose. It seems to me that if the States in the future did tax incomes a little stronger than they do at the present time, that the result is going to be that the States may possibly save for the local governments, property they now tax for themselves, and thereby the municipal governments might make up some of the loss in revenue. I instance this to you in my own State. The main source of State income up to say about 1900 was practically all from real-estate taxes, then they went gradually into corporate taxes, and finally went into the sales tax; and Michigan has now turned over to the municipalities, school districts, and municipal governments the entire tax on real and personal property.

So, it is hard for me to agree with the proposition that looking at the matter over a long period of time, that the Federal Government is not being at least fair in proposing to subject $40,000,000,000 of its securities and more to taxation, more than that when you consider the various Federal corporations, and only asking to tax about $16,000,000,000 of State and municipal securities.

Mr. CHATTERS. I am entirely with you on that proposition. My point is merely as far as the national economy is concerned, only with the effect that is produced on the principal of the whole economic system, regardless of its effect on individual departments.

The CHAIRMAN. Thank you, Mr. Chatters. The next witness is Mr. M. L. Seidman, of New York City, representing the New York Board of Trade. Mr. Seidman.

STATEMENT OF M. L. SEIDMAN, CHAIRMAN OF TAXATION COMMITTEE, NEW YORK BOARD OF TRADE

Mr. SEIDMAN. Gentlemen, I appear here as the chairman of the tax committee of the New York Board of Trade. When we speak of removing tax exemption from Government salaries and Government bonds, we mean, of course, that we want these to be subject to Federal and State income taxes to the same extent as are other salaries and other bonds, except those tax exempt bonds that are already outstanding.

Under the present arrangement, the Federal Government can, and to a large extent does, tax the interest from its own obligations. It also taxes the salaries of its own officials and employees. It does not tax the interest from obligations of States, municipalities or local governments, or the salaries of their officials or employees. And as to the States, those who impose an income tax do not tax interest from Federal obligations or income from Federal salaries.

The Federal Government now loses much more revenue through tax exemption than all State, municipal, and local governments combined could possibly gain if reciprocal exemptions were removed. Some of the reasons are: (*a*) Federal income-tax rates are much higher than those imposed by any of the States; (*b*) about half of the States and all of the municipalities and local governments have no income tax at all; (*c*) the amount of fully tax-free annual interest from obligations of States, municipalities, and local governments is much greater than from Federal obligations; and (*d*) the combined total of salaries paid by States, municipalities, and local governments is greater than that paid by the Federal Government. As to municipal and local governments, standing by themselves, they have everything to lose and nothing to gain by removal of tax exemption. Having no income tax to collect, they cannot look to any direct revenue in order to offset the increased cost of borrowing which is sure to follow removal of tax exemption.

Consequently, the controversy over this question seems to have resolved itself into a tug o' war between the Federal Government on the one hand which stands directly to gain by removal of tax exemption and the States and local governments, on the other, who stand directly to lose by it. In the process, it would seem that industry, which is to a large extent the taxpayer, is left in the position of the forgotten man.

This, it seems to me, is a controversy in which industry can be assumed to have an unbiased point of view that is entitled to great weight. For industry is here concerned only with the net effect of the proposal on the whole economic picture, regardless of its effect on the individual government departments.

The New York Board of Trade, according to its charter, exists "for the purpose of promoting trade, commerce, and manufacture of the United States and especially of the State and city of New York." Its members are, of course, vitally interested in city, State, and Federal tax policies. When, therefore, our illustrious mayor comes before you gentlemen to tell you that the city of New York stands to lose some $15,000,000 annually if Federal tax exemption is removed, we are seriously concerned. And, when our very able State comptroller comes before you to say that the State of New York stands to lose many additional millions on that account, we are also very much concerned. But, we realize, at the same time, that this is in the very nature of what must be expected as the direct and immediate consequence of ending tax exemption.

In his usual picturesque manner, our mayor has told you that the change would hit New York City "right between the eyes," and would make it impossible for the city to finance some of its pending projects. Without in any way reflecting upon the soundness of or need for these projects, I want to emphasize that, as a general proposition, the New York Board of Trade would not be at all averse to hitting the present pace of government borrowing and spending "right between the eyes." In fact, our chief objection to tax exemption is that it makes government borrowing and spending entirely too easy.

Because "a lot of mayors now have a headache," our mayor thinks this a bad time anyway to propose such a change. It would seem, however, that such a proposal is most needed when government is borrowing and spending most. And that is one field, as you and I know, in which new highs are now being made.

You have had impressive figures submitted estimating the increased interest cost of Government borrowing over and above increased revenue that would follow removal of tax exemption. We are told that money would cost government an additional 1 percent per year. What does that mean? Does it not mean that the present buyers of tax exempts consider themselves ahead of the game by accepting a lower interest rate in order to save taxes which they would otherwise have to pay? If that is true, then doesn't it necessarily follow that on net balance, government as a whole, Federal, State, and local, would, to the same extent, be ahead of the game if it paid the higher interest rate and collected the taxes from this source which it does not now collect?

Admittedly, the elimination of tax exemption would bring about some dislocation between the respective Government departments, but we who are concerned not alone with local costs and local taxes, but also with the related State and Federal problems, must necessarily take the broader view and see the matter in its entirety.

Possibly, the ultimate effect would simply be a balancing out of net cost as between one department of Government and the others. If that were all that is here involved, there would be little reason for our giving this matter so much attention. There is involved, however, something of much deeper significance. It is the matter of the effect

that tax exemption has on our economic well-being and our unemployment problem. If investment in productive industry has to any extent lagged because of this tax exemption, then the situation certainly calls for remedy. It is because I am strongly of the opinion that such exactly has been the case that I am here to urge removal of tax exemption.

While I would like to see the change brought about as quickly as possible, I am convinced that this must not be done at the expense of orderly constitutional processes. If there is serious doubt about the constitutionality of the proposed "short and simple statute," then by all means let's take the slower method; that of constitutional amendment. If that method seems too slow and inexpedient, it is surely the more advisable in view of the significance of the subject matter involved.

Our States being directly interested parties in the controversy, this may well be the ideal occasion to invoke the process of amendment by constitutional convention. That method would offer our people a direct opportunity to speak their collective mind on this subject. An amendment evolved in that form can probably be enacted in about a year's time. A statute might be enacted in a much shorter period. But in view of the certainty that any law enacted will have to go the rounds of adjudication through the United States Supreme Court, the orderly constitutional process may well prove to be the shorter in the end. At the same time, much confusion and uncertainty resulting from the litigation would be entirely avoided.

This would be true even if mere expediency were the only question involved, but the question is much more basic and fundamental. It involves the rights of every one of our 48 States and the power of the Federal Government over them. We will do well, therefore, to move with caution and with a full understanding of the significance of the problem. I shall make no attempt to delve into the legal controversy. That has already been covered quite thoroughly by others. Instead, I would like to confine myself to the economic phase of the problem as the businessman sees it.

Given a reasonable degree of safety of principal and income, the choice as between a stock or bond investment in private industry and a Government bond resolves itself down to a matter of attractiveness of net yield or possible net profit to the owner of capital.

Naturally, the higher the income-tax rate the more valuable the privilege of tax immunity, especially to the investor who has a large taxable income. The exemption feature becomes more and more an element of pressure in favor of Government tax-free bonds as income-tax rates move upwards. But until 1933, the effect was seldom to deprive industry of its normal long-term capital needs. Since then, however, another and more potent capital pressure has been at work. This new element, in conjunction with the old, has made the tax-free Government bond well nigh irresistible to the man of large taxable income. By this new element, I refer to the uncertainties that have been caused by Government policies and which private industry has had to cope with in its endeavor to attract long-term capital, especially common stock or equity capital.

Boot-strap economics, oppressive taxation, a series of unbalanced budgets, a spending spree under the heading of pump priming or Government investing, a string of reform laws enacted in rapid-fire

succession, and Government competition with industry, are only a few of the reasons why the future of private industry "has not looked so good" to the long-term investor. In consequence, there has been an understandable reluctance on his part, whether he be of small or large means, to entrust his savings to the future of private industry. Government has, as a result, become the chief long-term borrower.

Staggering amounts are today lodged in these tax-exempt securities. Their gradual elimination and the substitution of taxables would, of course, make a tremendous difference to those persons of large income who now find the tax-exempt security about the only haven of escape from an otherwise intolerably high income-tax. But it would also make a tremendous difference to industry and to labor, for the money invested in these bonds is the very kind of money that will gravitate to productive industry and employ labor. Much of it is enterprise money; the kind of money that can best afford to take business risks.

And yet, shutting the door to tax immunity is one thing while actually getting this money into productive use is quite another. Removal of tax exemption would certainly be an important step in the right direction, but only one of the necessary steps. Coupled with it would have to appear some concrete evidence that industry will not be harassed and that it will be permitted, or even encouraged, to earn profits. Unless that be the case, owners of such capital will simply not risk it in any long-term enterprise. Instead, they will seek either to employ their capital in short-term projects where the risk elements are more nearly predictable, or they will continue to lend to Government even at a very much reduced net return.

What is needed then, is not alone that lending to Government be made less attractive but also that long-term risk taking in private industry be made more attractive. That is the only effective means of closing the door of a lazy life to cautious money and at the same time induce it to go to work so as to earn profit for the investor, create jobs for the worker, and supply revenue for the government. And more important, that is the only way to revive our capital-goods industries, without the full functioning of which we have never yet had and never can have prosperous times in this country.

Such a highly organized economic system as we have developed must continually invest in plant, machinery, and equipment for increasing the productivity of the worker. Such a system calls for a constant stream of new capital for modernization and expansion. If the money already invested in a particular enterprise or if an industry as a whole, is earning a fair return, no difficulty is usually experienced in raising additional capital. But should industry be unable to, or should it not be permitted to, earn a fair return on investment, or should it be forced to operate at a loss for longer than a normal period, it will have much difficulty in attracting capital to meet its needs.

Our President's goal is an 80-billion-dollar annual national income. That is not an extravagant goal. That was about our national income in 1929, when our population was nine or ten millions smaller than it is today. But that goal can only be attained, and if attained, can only be maintained, by the full revival of private industry, particularly our durable goods industries which have not yet really emerged from a 10-year depression.

Government borrowing and Government spending under any name or under any label cannot permanently produce a level of national income short of bankruptcy. If every time the Government spends a dollar, $2 in the hands of private owners go into hiding or are discouraged from active participation in productive industry, permanent business revival is clearly impossible.

We are not short of capital. If anything, we have too much of it. But it is a discouraged capital. There are possibly more discouraged dollars awaiting profitable investment today than at any other time in our financial history. What we are lacking is not financial means, but a willingness on the part of owners to risk these means against too many odds. Careful people who have some savings consider it much the smaller risk, and on the whole much more attractive, to lend to Government than to invest in industry. Here it may as well be frankly admitted that so long as enterprise capital is discouraged and money seeks security of principal, Government can probably continue for a long time to borrow vast sums at little, if any, additional interest cost, even without tax exemption. But that will not revive industry or return our army of unemployed to private payrolls.

Even when we do close the door to the haven of tax exemption and open it wide to investment for profit in private industry, there still would remain the very important question of how much of the profit, if and when made, will be taken by Government in taxes. This business of enticing capital to take risks in venturesome enterprise is not a mere matter of evolving a mathematical or financial formula upon which the investor can be expected to act. There is a human element involved which requires recognition. It is the urge for gain even at the risk of loss of one's capital. If, all things considered, a net gain is too doubtful of attainment, the risk will not be undertaken. And our failure in the past to fully appreciate the real importance of this principle in the formulation of our tax laws has militated to our great disadvantage.

Every job in private industry owes its existence to capital taking risks. Every new job to be created by private industry must depend upon the same motive power. Yet, our tax treatment of capital gains and losses has been such as to utterly discourage risk taking for gain. Even our present Revenue Act, which in this regard is a considerable improvement over some of the previous ones, still treats capital gains and losses as if to penalize rather than encourage enterprise. Short-term gains are still subject to full tax rates which reach as high as 79 percent for Federal income tax alone. And if the result is a loss instead of a gain its tax deductibility is limited and circumscribed. Long-term gains (investments held over 18 months) are now limited to a 20-percent maximum tax. This State income taxes frequently increase to 25 percent or more; much too high a tax on capital gains for maximum economic and social benefit.

But it was not on that account that our President refused to give his approval to the 1938 Revenue Act. To the contrary, it was the stopping at the 29-percent point instead of continuing on up the scale of progressive surtax rates that he complained of. And he indicated that this Congress will be asked to tax capital gains at more progressive rates. The very fear of such increased taxation may alone be sufficient to deter the investor from risking his savings for a possible long-term gain. At least it should be obvious that the tax factor is

a very important element in the whole problem of investment for profit, and that it can well nullify any good results that would otherwise accrue from the elimintaion of the tax-free Government bond.

As Ralph Hendershot, the financial writer of the New York World-Telegram, recently said on this subject, "If Uncle Sam wishes to catch the horse of capital in the pasture of economics he would do well to stop chasing him and, instead, hold out a panful of oats."

Closely affiliated with the problem of borrowing and perhaps more difficult of solution, is that of run-wild Government spending. Our normal pre-New Deal annual Budget was less than $4,000,000,000. Now, it is almost twice that much. In 6 years, a 100-percent increase of normal Government expenses. We speak of being on easy street if we could but get our national income back to an $80,000,000,000 basis. But when our national income was that, the cost of running our Federal Government was less than half what it is today. We are now spending at the rate of nearly $10,000,000,000 a year, and it is perfectly obvious to anyone who is but willing to see, that a drastic reduction in the cost of Government is imperative if we are ever to regain our financial sanity.

I am not fooling myself about the difficulties which lie in the path of reducing Government spending. In spite of the graveness of the problem, there is little likelihood for spending to be greatly reduced until popular will encourages such a course. I know it will hardly be popular to undertake radical reduction of expenditures for relief, for public works, for social security, for pensions, for agricultural subsidies, or for so many of the other Government expenditures which are rapidly becoming vested rights on the part of their recipients. Yet, expenditure reduction on a substantial scale there must surely be. For, in the next 18 months alone, our Federal expenses will exceed revenues by the staggering sum of $5,700,000,000; and no end in sight.

Governmental unbalanced budgets financed by borrowing chiefly from banks, are definitely a form of progressive inflation. Their effect in the long run is exactly the same as that produced by printing press money. The process may be slower, but the ultimate effect is just as devastating. How long we can continue on this course before real trouble develops is difficult to say. Ours is a large country with vast resources and it can stand a great deal. But no nation on earth, regardless of its resources, has ever escaped financial chaos and ultimate financial collapse if it failed in time to curb continuous and substantial budget deficits. Certain it is that most persons called upon to trust the future with their present savings are in agreement with what President Roosevelt himself said in 1932 about loose fiscal policies of government, namely, that they are "a veritable cancer on the body politic and economic."

It is here that the taxing of now exempt Government salaries takes on an aspect of major importance. Not for the amount of tax that the Federal Government can collect from these 2,600,000 State, municipal, and local government employees whose salaries are now wholly exempt from Federal income tax or the 1,000,000 or more Federal employees whose salaries are now exempt from State income tax, but for the greater tax consciousness that the removal of such tax exemption will create on the part of these people and those they influence.

It is useless to appeal to the present income taxpayers in an attempt to influence Government spending policies. They are much too small in number to have any real effect politically. Due principally to our system of large personal exemptions, there are only about 2,500,000 individuals who pay any Federal income tax at all. This is not to say that the remaining 128,000,000 people do not pay taxes, but it is to say that they do not pay them directly and knowingly. That is the great crime of our taxing system.

In spite of the fact that about one-fifth of our entire national income is consumed by taxes, the average man pays mighty little of his share directly as taxes. His taxes are instead hidden in his cost of living; and because he pays little, if anything, directly, he is usually under the impression that it is the other fellow and not he who is footing the bill for Government spending. Until we obtain in this country a much larger number of direct taxpayers who are keenly conscious of the fact that their own tax bill varies in direct proportion to Government spending, there seems little basis for hope that Government spending will be greatly reduced.

In removing tax exemption from this large army of persons who are closest to Government, I see an opportunity to greatly increase the number of those who will hereafter pay their tax bill directly and knowingly and thus to bring about a much keener interest in Government spending policies than exists today. That, to my way of thinking, would be the most important achievement that removing reciprocal tax exemption from Government salaries can result in.

I do not anticipate that after the situation adjusts itself, the net Government revenue from this source, Federal, State, and local, would be increased to any great extent. Rather am I of the belief that the Government employee now pays well for this privilege of tax exemption and that on balance, he may perhaps be ahead of the game if he were paid what is due him as salary. This would at least be calling a spade a spade both as to his own pay and as to the amount that he in turn is called upon to pay for Government spending. This vast army of Government employees might then well become an army of model taxpayers for other of our citizens to emulate and follow.

In conclusion, therefore, I urge upon you to take such steps within constitutional propriety as will make it possible for the Federal and State Governments to reciprocally impose income taxes on all Government salaries and all interest from Government obligations hereafter to be issued.

The CHAIRMAN. Thank you, Mr. Seidman.

We will now hear from Mr. Henry Epstein, Solicitor General of the State of New York, representing the attorneys general of the States submitting a defense.

STATEMENT OF HON. HENRY EPSTEIN, SOLICITOR GENERAL OF THE STATE OF NEW YORK, REPRESENTING THE ATTORNEYS GENERAL OF THE STATES THROUGH THE CONFERENCE ON STATE DEFENSE

The CHAIRMAN. Before you start on your statement, Mr. Epstein, I hope that you will touch as lightly as possible on the economic problems on which we have had statements, for the past several days.

Mr. EPSTEIN. As a matter of fact, I do not think I will touch on the economic problems at all.

The CHAIRMAN. What I was saying to you, I want to say for the information of all of the others who present the legal and constitutional aspects of this matter.

Mr. EPSTEIN. That is true.

Now, Mr. Chairman, may I ask to have marked in evidence before your committee the legal brief of the attorneys general of 39 States and counsel for certain of their municipal subdivisions. Of course, we do not ask that it be printed.

The CHAIRMAN. It will be received.

(The brief entitled "The Constitutional Immunity of State and Municipal Securities—A Legal Defense of The Continued Integrity of the Fiscal Powers of the States—by The Attorneys General of The States and Counsel for Certain of Their Municipal Subdivisions" was received and is on file with the committee.)

Mr. EPSTEIN. The conference of forty-odd States, which I have the pleasure of representing, was formed to present to such bodies as your committee the attitude of the States on legislation of this character which those States felt go to the roots of our constitutional system of Government.

There are 39 attorneys general signatory to this brief, and the very array itself would indicate to this committee, or to anyone reading it, that it does not in any way partake of any partisan or political character whatsoever.

We are very glad to note in the press this morning, and I have just been handed a copy, and had a chance in the last few minutes to read one or two of the conclusions reached by the staff of counsel to the Joint Committee on Revenue Taxation, which is identical with the conclusions which the States have reached independently.

The CHAIRMAN. May I ask, is there any significance in the fact that nine State attorneys general did not join in this brief? Does that indicate they take an opposition view?

Mr. EPSTEIN. That is not our opinion, because, at the conference of State defense at Cleveland, at the time of the meeting of the American Bar Association last year, the resolutions adopted were adopted unanimously, and we have 45 State members of the conference, and we have not received any contrary opinion. It was just that we were unable to obtain from them approval of the brief when it was sent to them.

I am advised by Mr. Tobin, the general secretary of the conference, that there was only one refusal, and that was from Colorado.

Now, may it please the committee, the question has been raised here, the old question or the so-called question of States' rights has been raised at this time, which is, in the history of this country, an attempt to go back some 75 years and to revive the experience of the conflict that was determined in the sixties.

In my background, I happen to have been suckled upon these States' rights, having been born in South Carolina. However, I had schooling of the North, and a New England background, and the question of States' rights, as presented by the conference of States, here, is one which has grown out of the progress of our economic history, and not at all the States' rights doctrine which was determined in the conflict between the States three-quarters of a century ago.

It has been the uniform history of nations and of peoples that, as long as they have a frontier to which they could advance, where they could wring from the soil a livelihood for the necessities of life, there has always been the solution of such economic problems as might arise.

This country well knows that the direction of Horace Greeley, "Go west, young man!" was used as a relief of economic conditions in the past, and the development of the States. We went ahead with that economic process when the last of the covered wagons crossed the Great Divide to the landed frontier as a solution of overcoming the problems in this country, and it was at an end.

The European nations have sought by imperialistic aggression, to go back of the march of time and utilize that method to solve their problems, to which this Nation, fortunately, is not a subscriber.

Fortunately for our history and the people of this country, with the combination of the landed frontier, as a solution to our economic problems, there came the great industrial frontiers, the great industrial development of this Nation. As the result of the reflex, or the revolution in this country, which was reflected by the development of the great industrial frontier, and the factory system, we thought, furnished a solution, and the industrial frontier became a solution to the decreasing of economic hardships in this country.

Then, however, when you reach the situation where you produce some 12,000,000 automobiles for a market that would be well satisfied with 8 or 10 million automobiles, and when your production has been speeded up to that stage where there was not a counterpart of consumption, we had reached what we believed was the end of the so-called industrial frontier, and the sole solution of the economic problem.

That brings us to what many believe to be the last frontier for the economic solution of our problem, and that is the solution, or the frontier, of the human mind, as exemplified in Government, and the solution which must be met through political mechanics to solve economic problems.

How does that bear upon the question of States' rights?

With the realism that the land and industrial frontiers as solutions of our economic problems have gone, we are faced with the adoption of political methods to attempt to solve these problems, and the pressure of this economic problem, through political mechanism, may, unless carefully analyzed, lead to that which is obviously most feared, the centralization of all economic power, through political mechanism, in a certain point, for the Nation as a whole, and the result that that may be far more complicated in the future than we can foresee.

It is the inherent political problem that is presented as a result of the pressure of economics upon the last frontier that we have, the frontier of the mind, exerted in the Government to solve this problem.

To solve this problem we are concerned with, seriously and honestly, there is perhaps in this proposition one of the most dangerous weapons that can be used for the destruction of the constitutional form of government as we know it.

President Woodrow Wilson said:

> Things get very lonely in Washington sometimes. The real voice of the great people of America sometimes sounds faint and distant in this strange city.

We submit at the outset that the preservation of the integrity of the State and local governments is probably the most essential political

factor and danger before this country today in the march of political events as the result of economic pressure.

In the President's message and in the publicizing of the program for taxation of State and Federal securities, the sixteenth amendment has been utilized as the basis upon which Federal taxation of State and municipal securities may rest.

It has been stressed in the argument of the Government, and it is popular with the columnists and editorial writers, and where it is referred to in the second part or the third part of our brief, in view of the stress laid upon it in the argument, and the debate before the House of Representatives, which I had the pleasure of attending yesterday, I should like now to take up, with your permission, the question of the sixteenth amendment first.

That amendment reads, as you know:

> The Congress shall have power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Government, in its legal brief—what we term the White Book—makes this statement:

> This necessitates an examination of the nature, background, history, scope and reasonable intendment of the sixteenth amendment.

That statement appears at page 90 of the Department's White Book, and is in perfect accord with what we know, as lawyers, to be the cardinal rule of construction of constitutional or legislative matters.

If you go to the sources, the current debates before the legislative bodies, you can ascertain beyond reasonable doubt what was the intendment, and then the proposed language will be so construed.

Even the courts have held that the actual construction over a long period of years, say half a century, is sufficient to give sanction to the construction of the Constitution as this applied.

On page 95 of that same brief the Government says:

> The only permissible constructions of the amendment are so clear as to render improper references to the external evidence.

At one point they are willing to accept the cardinal rule, but, when it goes against them, they cast it aside.

The doubt, if any, before legislation is enacted, we submit, should be resolved in favor of the reservation, or what has been regarded for over a century and a half as the basis of our Government.

The sixteenth amendment went into effect in 1913, and we are glad to note that in 1937 the counsel for the Joint Committee on Internal Revenue Taxation was of the same view as he represents in his report to your committee, that the Federal Government has no power to tax the obligations or interest thereon of States or political subdivisions of States.

The power of the National Government to levy and collect taxes and duties has never at any time actually been challenged. It existed before the sixteenth amendment, and it has existed after the sixteenth amendment, and the fallacy of the Government's position in its brief is demonstrated in the language which it used, because they seek to draw a conclusion from language that is not in the amendment.

For example, they say, at page 94 of the White Book:

> * * * external evidence will show that the Congress did not have the substantive power to impose an income tax, based upon the principle of ability to pay, because it was a practical impossibility to apportion such a tax.

In other words, Government counsel argues that, because it is impractical to impose a tax, the National Government did not have the power to impose the tax. The authorities are clearly to the contrary.

Senator Root, for example, in 1910, in writing to Senator Davenport of New York, said:

> The amendment will be no new grant of power. Congress has already the power to impose taxes on incomes from whatever source derived, subject to the rule of construction which excludes State securities from the operation of that power; but, the taxes so imposed must be apportioned among the States.

The Supreme Court, in the *Pollock case*, *Pollock* v. *Farmers Loan & Trust Co.*, 158 U. S., said:

> The power to tax real and personal property, and the income from both, there being an apportionment, is conceded.

Senator Borah, in the Forty-fifth Congress, said:

> I submit that this amendment, if adopted, will add nothing to the power of the National Government to lay and collect taxes in the way of power, that the power of the National Government at the present time is full.

The Senator is today of the same opinion. In a letter to the vice-chairman of the Conference on State Defense, dated October 17, 1938, Senator Borah said:

> In the first place, I do not think Congress would have the power to tax these securities and instrumentalities of the State without a constitutional amendment. In the second place, as a matter of policy, aside from the constitutional question, it is unsound and would be a disaster to the States and, I am quite sure also, a disappointment to the National Government.

Now, no question was raised until the Civil War as to the validity of any income tax, and no question was raised when the Civil War income tax was passed.

The Constitution provided that no direct tax should be laid unless in proportion to census, which directed that a census should be taken, and the real test came after the sixteenth amendment grew out of the two Pollock cases, that is, *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. and 158 U. S.

I think I should review briefly the facts in the case. Pollock, a shareholder of the Farmers Loan & Trust Co., of New York, sued on behalf of himself and all of the other shareholders similarly situated, to restrain the payment of income tax that had been levied.

The 1894 act, under which the tax was thought to be levied, stated:

> That there shall be assessed, levied, and collected and paid annually upon the gains, profits, and income received in the preceding calendar year by every citizen of the United States, whether residing at home or abroad, and every person residing therein, whether said gains, profits, or income be derived from any kind of profit, rent, interest, dividends, or salary, or from any profession, trade employment, or vocation carried on in the United States or elsewhere, or from any other source whatever—

The bill of complaint of this stockholder who sought to enjoin the tax upon the income, which was derived from the following sources:

(*a*) From real estate;
(*b*) From New York City bonds; and
(*c*) Other bonds and securities.

The contention was that a tax upon the income derived from real and personal property was a direct tax, and, therefore, subject to the rule of apportionment.

The Court, in the first case, was divided, two of the Justices writing dissenting opinions on the question of income from real estate, holding that it was a direct tax and subject to the rule of apportionment, but, because the Court was evenly divided upon the validity of the tax upon income derived from personal property, a reargument was ordered.

The Court held, in that first case, that the income from salaries or business properties was not a direct tax, and, therefore, could be reached through income tax, before the sixteenth amendment.

There was one point, however, on which the Court was unanimous, and on which the Court has been uniform in its decisions ever since, and that is that the State cannot tax the bonds or the operations or the property of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States has no power under the Constitution to tax either the instrumentalities or the property of the State.

The Court, in the same opinion, said:

> But we think the same want of power to tax the property or revenues from the States or their instrumentalities exists in relation to a tax on the income from their securities—

Senator MILLER. Right there, on that immunity rule, since that time has there been any relaxation or modification of that rule by subsequent decisions that would tend to sustain the position of the Department of Justice?

Mr. EPSTEIN. We do not believe that there has.

Senator MILLER. I have read all of the briefs very closely, and that is the reason I asked the question.

Mr. EPSTEIN. After I have submitted the argument on the sixteenth amendment, I shall discuss those cases in which that question is raised.

Senator MILLER. I did not mean to interrupt your train of thought.

Mr. EPSTEIN. The reason I wish to divide my discussion this way is this, that if the *Pollock case* be deemed to have been wrongly decided——

Senator MILLER. You know there is a lot of criticism of the *Pollock case*.

Mr. EPSTEIN. Yes, sir.

You see, the *Pollock case* involved three or four points. It was unanimous on one point, and the Court has consistently held the same way, I might say, insofar as the taxing of the property or income of contractors who deal in Government contracts, and the profit derived from the sale of municipal or State security or lease of State lands, and so forth. Those are cases which are relied on by the Government, and I shall discuss them further in my agrument.

Senator MILLER. I have no desire to interfere with the orderly presentation of your argument, if you have them in order.

Mr. EPSTEIN. I have, and we shall argue them and show clearly to the committee the facts.

Senator MILLER. Go right ahead.

Mr. EPSTEIN. I shall discuss at length the dissenting opinions of Mr. Justice White and Mr. Justice Harlan.

These two Justices agreed with the majority of the Court on the question of the bond opinion, but they also held in their dissenting opinions that instrumentalities employed by the States in the execution of their powers are not subject to taxation by the General Government any more than the instrumentalities of the Federal Government are subject to taxation by the States.

And any tax imposed directly upon interest derived from bonds issued by a municipal corporation for public purposes under the authority of the State, whose instrumentality it is, is a burden upon the exercise of the powers of that corporation which only the State creating it may impose.

In the second *Pollock case*, which involved the reargument on the principle that the taxation of the income from personal property was a direct tax, and, therefore, must be apportioned in the following year, and that case was decided by a five-to-four decision, Justices White, Jackson, Brown, and Harlan dissenting.

In that second decision, the Court held that the income from personal property was a direct tax, and, therefore, subject to apportionment.

It had previously held, as you know, that a tax on real estate was a direct tax, and again the unanimous Court indicates in its opinion that, as to the income of municipal bonds, they could not be taxed because of want of power to tax the source, and no reference was made to the nature of the tax as being direct or indirect.

The Court swept that aside, and Chief Justice Fuller, in the second case, summarizes those reasons I have given here.

The CHAIRMAN. I do not think there is any question about that, and, as I recollect, I asked Mr. Morris that question. The opinion of the Court was unanimous as to the nontaxability of municipal and State securities by the Federal Government. That was upheld.

Mr. EPSTEIN. Of course, the reason why the sixteenth amendment had to be adopted, in view of that decision, is perfectly obvious. If you had $500,000,000 to be raised, and you had 100,000,000 people in 20 States, New York with 10,000,000 would pay $50,000,000, and Minnesota, with 2,500,000 people, would pay about $12,500,000; whereas, on the basis of income, it was shown that in 1921 and 1922 New York State paid over $525,000,000, and Minnesota paid only approximately $30,000,000; and that exemplifies the basis for the sixteenth amendment, and why it had to be adopted.

President Taft, in making his recommendation in 1909, said that, as to the power of the Government to levy income taxes, the amendment was necessary to recover the power to levy income taxes upon the people without apportionment among the States.

Now, the Government lays great stress on what they refer to as the debates in the House, and the only reference that can be found in the record of the debates is the speech by Representative Harrison, of July 12, 1909, in which he presented this resolution before the House, at which time he said:

> This resolution now before the House provides for the taxing of incomes from whatever source derived. That means taxes upon the incomes of corporations as well as individuals.

That is the only source and the only evidence in the House debates that you can find upon the particular phase that is utilized so much in

order to try to convey the impression that there is a grant of power for all income taxation.

Now, in the Senate, the resolution for the amendment was introduced by Senator Brown, of Nebraska, in April of 1909, and in the Senate there was no doubt whatsoever, from the Senate records, as to what was the meaning and intention and purpose of the sixteenth amendment. The Senate records are replete with statements and challenges to any question whenever it was raised.

The question of the taxation of municipalities or States, or the revenue from municipalities, was never even contemplated or raised, or any such phase indicated, until Governor Hughes, in his message to the legislature of the State of New York, called attention to that possible danger.

The Treasury, in its brief, refers to and places considerable stress upon what they call certain new evidence that they have uncovered. That new evidence, it appears, consists of letters written by Senator Knute Nelson to a man named Harry Hubbard, published in the American Bar Association Journal. The letters were written in 1920, about 11 years after the debate upon the floor of the Senate. In the letters, Mr. Nelson refers to himself as the introducer and the framer of the amendment. The record shows that Senator Brown, of Nebraska, introduced the amendment, and the report of the newspapers at the time gives credit for the phraseology of the amendment to Senator Root of New York. It is to be noted in Mr. Stam's report that researches were made much further than our own on the question of the Nelson letter. Senator Nelson, as we were able to ascertain, was not only not a member of the committee, but did not participate in the debate.

On page 26 of the report, counsel indicates that the record of the Senate discloses that Senator Nelson was present in his place on the floor of the Senate when the debate took place, when Senators Borah, Brown, and Root made it perfectly clear that it was not intended to cover any such source, and it is remarkable that the counsel of the committee indicates that he never uttered a word, and the only expression that he gives was a letter some 10 years later.

Now, the same argument of taxing the wealthy that was advanced today was advanced then, but it is significant that it had a considerably different meaning at the time that the sixteenth amendment was under discussion.

For example, the Congressional Record shows that in the debate the point was made that men like Carnegie, who then was the holder of more than $300,000,000 of the securities of the United States Steel, should be taxed, and it was the purpose to reach this income.

That is natural, because, the evidence discloses that in the whole Nation at that time, in 1913, there was not more than $5,000,000,000 in tax-exempt securities outstanding, and the total of State, county, and municipal securities outstanding was only about $1,800,000,000.

So that the situation as it exists today was not so important at that time.

The CHAIRMAN. May I interrupt you to see if I have the same recollection of these occurrences which you have just been discussing?

As I gather—and you tell me if I am wrong—there was slight discussion in the House, but no discussion in the Senate, on reasons for the inclusion of this apparently unnecessary phrase, "from whatever

source derived," prior to the submission by the Senate of the amendment to the States, but when it already had been submitted and it was only after Governor Hughes of New York called attention to this interpretation, which he apparently put on it, that there was a discussion on the floor of the Senate, in which Senator Brown, of Nebraska, and Senator Borah, and Senator Root, and others took part, in which they stated that the phrase, "from whatever source derived," was not intended to include the power to tax State and municipal securities—the point being that there was no discussion, practically, in the Senate, and none in the House, upon the precise question involved. That is the real situation.

Mr. EPSTEIN. That is true.

Senator MILLER. They did not go so far as to bear on the question of the intention or nonintention of taxing these securities?

Mr. EPSTEIN. Yes; they did. I will refer you to the quotation from the debate. Senator Brown and others made it perfectly clear, and, in fact, Senator Borah introduced a resolution in the Senate asking that the Judiciary Committee adopt that resolution in order to express the formal view that there was no such intention.

The CHAIRMAN. But that was not done.

Mr. EPSTEIN. The resolution was introduced.

The CHAIRMAN. I think, to have the record straight, my namesake, Senator Brown, wobbled about quite considerably in his statement of his views.

Mr. EPSTEIN. I do not know that you could call it wobbling, if you read the record.

The CHAIRMAN. I do not agree with you on that. It seems to me that he jumped on both sides of the question, which I hope his successor will not do.

Mr. EPSTEIN. You will excuse me for taking a different viewpoint. It is clear in his debate that he referred to corporations and individuals, and when you have the quotation referring to the income from real estate, the income from bonds, the income from personal property and corporate bonds, and otherwise the income from salaries and other personal property, you have the background for the use of the words, "from whatever source derived," without regard to the supplemental question of the tax on the bonds of governmental property, and, therefore, while you cannot see the debate explaining it before the resolution, that is a perfectly clear and logical explanation of it.

The fact of an uninterrupted practice over a long period of years affords a basis for any judicial interpretation that has been so universally accepted that to upset it today would not only undermine the stability of judicial interpretation of the Constitution, but seriously affect the actual operation of the Government and the philosophy of that Government.

The CHAIRMAN. Are you going into the question of what the Governor said to the State legislature?

Mr. EPSTEIN. We have a complete record of that on page 289 of the brief. Senator Borah recently advised the solicitor general of the State of New York that if, during the course of the discussions in the Senate, there had been any disagreement in the Senate with the views which he expressed, he would have pressed his resolution for adoption. His recollection is that the Senate was so unanimous that there seemed to be no further point to it.

The CHAIRMAN. Which was after the Senate had acted in submitting it to the States.

Mr. EPSTEIN. That is true.

Governor Hughes expressed his fears in 1910 to the New York Legislature that the words "from whatever source derived" would include, not only income from personal property of individuals and corporations, but also income derived from State and municipal securities.

That was a bombshell, which immediately created the cause of the debate, and Senator Borah stated that:

> This amendment, if adopted, will add nothing to the power of the National Government to lay and collect taxes in the way of power.

And so forth. Not only did Senator Borah take that attitude, but Senator Brown introduced the amendment, and Senator Brown was the one asked to have laid before the Senate, Senate Resolution No. 175, which was introduced on the question of the interpretation. This resolution reads:

> *Resolved*, That the Committee on the Judiciary be, and is hereby directed to report to the Senate as early as may be practical, whether in the opinion of the committee the proposed amendment to the Constitution of the United States as submitted to the States for ratification at the special session would, if adopted, authorize Congress to lay a tax upon incomes derived from State bonds and other municipal securities, or would authorize Congress to tax the instrumentalities or means and properties of the States, or the salaries of State officers.

That was offered in the Senate by Senator Brown, who introduced the amendment.

Mr. TOBIN. It was Senator Borah who introduced the resolution.

Mr. EPSTEIN. My attention is called to the fact that it was Senator Borah, but Senator Brown did say:

> The proposed amendment has a single purpose, and that is to confer on Congress the undoubted power to tax incomes directly without regard to apportionment.

Now, Senator Root left no doubt as to his views on the matter, and made answer on the floor of the Senate to the fears of Governor Hughes and also, in a letter to the New York Legislature, disagreed with the Governor.

It is of particular significance that Governor Hughes, himself, not only on the bench but, in 1925, as a private practitioner, wrote opinions in which he expressed clearly the view that such income from State and municipal securities were not taxable under the income-tax law.

The New York World, in its editorial columns, referring to the statement of Senator Root, said:

> Mr. Root proves that the amendment does not open a way for the taxation of State securities. He shows that the words "from whatever source derived" are solely designed to meet the situation raised in the decision of 1895, which distinguished between income from personal property and income derived from business or occupation.

We have quoted at considerable length the statements of Mr. Root in the brief, and it is clearly indicative that there was no doubt whatsoever.

Now we come to the question of the ratification.

The Department of Justice states that there were 52 messages of governors, and, in fact, there were 53 messages that we have suc-

ceeded in finding, and of these 53 messages, 39 make no reference to Governor Hughes whatsoever, inferentially or otherwise, and 13 messages do refer to Governor Hughes' fears, but, of those, only 3 agreed that those were fears which might truly be maintained, whereas 7 disagreed, and 2 stated both sides of the question without any recommendation on either view.

However, the view of Governor Hughes is played fortissimo, and the others, pianissimo.

The interpretation by legal scholars has been uniform on the question of taxation of State and municipal bonds and their interest under the sixteenth amendment.

Professor Thomas Reed Powell, formerly of Columbia University, but now with Harvard, said that the phrase, "from whatever source derived," added nothing to the force of the amendment, but merely removed the requirement of apportionment which, of course, was made unnecessary.

Senator Kellogg, in 1918, made a similar statement:

> The sixteenth amendment does not confer any power to tax any article which Congress could not before properly tax, but it simply removed the rule of apportionment among the States, according to census.

All other branches of the National Government have given uniformly that interpretation to it, even the Treasury Department in 1937. On June 10, 1937, Under Secretary Magill wrote to Senator Lonergan, in which he states:

> Unfortunately it seems perfectly clear under the decisions of the Court that the desired result cannot be attained in the case of State and municipal issues by any action short of the submission and ratification by the States of a constitutional amendment.

In 1924, when the question of amending the Constitution to permit the taxation of State and municipal securities was before Congress, Congressman Green, of the House Ways and Means Committee, reported that the Congress was of the opinion that the change required a constitutional amendment. He said:

> The majority of the committee are convinced that a tax cannot be levied on the income derived from State and municipal securities or securities issued by any political subdivision of the State without provision being made therefor by a constitutional amendment, or, in other words, that under the decision of the Supreme Court such a tax is now inhibited by the Constitution. Judicial interpretation has been uniform upon the question.

Professor Magill thus summarizes it:

> The Court has many times indicated, however, that in its opinion the sixteenth amendment did not extend the taxing power to new subjects; but simply put at rest the contention that an income tax, being a direct tax on property, must be apportioned.

The first case that came up after the sixteenth amendment was the case of *Brushaber* v. *Union Pacific Railroad*, and in that case the Court made it perfectly clear that the power to tax the income from municipal and State securities was not conferred.

The case of *Peck* v. *Lowe*, in 1918, followed, and the Court said:

> As pointed out in recent decisions, it (the sixteenth amendment) does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on incomes, whether it be derived from one source or another.

In *Metcalf* v. *Mitchell*, Mr. Justice Stone writing the unanimous opinion, the Court said:

> The sixteenth amendment did not extend the taxing power to any new class of subjects.

In the case of *Willcutts* v. *Bunn*, the Chief Justice made it perfectly clear. He stated:

> In the case of the obligations of the State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligation.

In every one of the decisions that have come up that have involved the question directly or indirectly, the same conclusion has been drawn by the Supreme Court, by every one of the Justices, and the only single question as to the constitutional interpretation of the sixteenth amendment in the personnel of the Court is singly and alone the concurring opinion of Mr. Justice Black, at present a Justice sitting on the Court, and formerly a Senator, and there is not a single other Justice sitting on the Court that has expressed himself otherwise. We have no expression from the recently appointed Justice, Mr. Justice Frankfurter.

The Hughes fears have now been construed as the program of the Treasury Department, in order to obtain, through legislation only, an attempt to reach the income from State and municipal securities.

We submit, that the test, that must necessarily prevail regarding the contesting of statutory or constitutional provisions, is that you must go to the source, and, if from that source you can find in unequivocal language what was the intent and the purpose, and, following that, what course the courts have uniformly adopted, it is destructive of the cardinal rule of interpretation, and destructive of anything that goes to the fundamental rule of jurisprudence to attempt to throw that over.

Here is an attempt to inject into the question an entirely new field for economic reasons.

One might argue that the *Pollock case* was wrongly decided, and, having been wrongly decided, the sixteenth amendment was unnecessary.

That being so, the question always is, whether or not a statute, enabling the United States to tax securities or the income from securities or the revenue of the States or municipalities, is valid without the *Pollock case* and without the sixteenth amendment.

In 1923, the committee report of the House Ways and Means Committee indicated that a majority of that committee felt that it could not be done without a constitutional amendment.

Now, the reason for that would seem to be perfectly clear. The courts have never once, in all of their history, wavered from the fundamental proposition that this Federal Government consists of a balancing, not only of the three departments in the National Government itself, but a delicate balancing of State and Federal powers, and that that balance must be maintained if the constitutional system of government that we have is to be preserved.

In at least 34 cases the Supreme Court has never once wavered from the principle that the rule of immunity is a reciprocal rule.

The Department of Justice would have us believe that, after 70 years of continuous construction, the courts might wake up and discover that they had been applying the wrong rule of law.

The Department of Justice indicates that *Collector* v. *Day* was the first case in which this principle was before the Supreme Court.

A careful search shows that, while we can understand, having accepted, the principle of reciprocal immunity, no one would ever raise the question in the United States Supreme Court. We do find, however, many State cases in which the question was raised, and we have enumerated them in our brief. From 1864 to 1870, State immunity was unanimously upheld by the highest courts of Alabama, Arkansas, California, Connecticut, Georgia, Illinois, Indiana, Michigan, Mississippi, North Carolina, and Wisconsin, and no one of these cases was ever taken to the United States Supreme Court.

Now, where do we get the initial basis of this so-called reciprocal doctrine, as well as the origin of the so-called doctrine of national supremacy? It is derived—at least, most of the legal scholars think it is derived—from *McCulloch* v. *Maryland*, but it is distinctly important to remember that the emphasis that the Department of Justice places upon the national supremacy through *McCulloch* v. *Maryland* is not the emphasis that applies today.

When *McCulloch* v. *Maryland* was decided, you had 13 States riding rampant in their pristine position of power, and they sought to establish not a National Government in Washington, but only a Federal system in the National Government under granted powers they can operate under, and Chief Justice Marshall himself in that decision gave evidence of reciprocal features.

He said:

> We have a principle which is safe for the States and is safe for the Union. We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from the repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve.

We respectfully submit to this committee that the peak of the building up of the Federal system, what the Federal Government should do in the advance of our frontiers, as I have indicated, was reached with the Civil War, and since the Civil War there has been a development in the course of time, a development of the national power, and the issue before the Congress of the United States today is whether the States shall be preserved in their entirety, and we consider that is perhaps the most vital issue of political significance that has arisen since the Civil War.

Coming now to a group of cases which are significint in this discussion, we have the case of *South Carolina* v. *United States*, where the United States Supreme Court authorized and held valid the taxation of the liquor business when engaged in by a State, and in that decision the Court said:

> To preserve the even balance between the two governments and hold each in its separate sphere is the peculiar duty of all courts, preeminently of this, a duty oftentimes of great delicacy and difficulty.

Mr. Justice Stone reasserted the doctrine in *Metcalf* v. *Mitchell*, in which he said:

> The familiar aphorism is "that as the means and instrumentalities employed by the Federal Government to carry into operation the powers granted to it are exempt from taxation by the States, so are those of the States exempt from taxation by the Federal Government."

All other communications that give expression to these views are dismissed by the Government in its brief as being dicta, and yet they have not been able to marshall even one dictum contrary to all of the decisions of the court.

Senator MILLER. May I interrupt you there?

You mentioned some State cases. I do not remember the Arkansas decision, but I want to inquire as to how the questions arose in those State cases.

Mr. EPSTEIN. Typical of these is the case in the Indiana court of *Warren* v. *Hall*. That says:

> We start then with the constitutional fact that State governments are to exist concurrently with the United States Government possessed of independent powers beyond the control of the United States Government, that they and their people possess all powers not granted to the United States. The argument applies with full force to the exemption of State governments from Federal legislative interference.

Cooley announced the reciprocal nature of the immunity rule. He said:

> If the State cannot tax the means by which the National Government performs its functions, neither, on the other hand, and for the same reason, can the latter tax the agencies of the State governments.

Senator MILLER. But this is the question that bothers me, just how the question could arise in a State court on the authority or power of the Federal Government to levy a tax on the income of State securities; I just do not see how that question could get into a State court.

Mr. EPSTEIN. There might have been a State license, and the Federal excise tax, and it was an attempt by the Federal officer to collect in the State court the excise tax of the Federal Government.

Senator MILLER. Is there reference to those in your brief?

Mr. EPSTEIN. Each one is cited in the brief on pages 57 and 58.

Senator MILLER. Go ahead. I did not mean to interrupt you.

Mr. EPSTEIN. Now, the whole discussion of this particular session has been given impetus by the Supreme Court in its decision in *Helvering* v. *Gerhardt*. If I may be permitted, I wish to review that to emphasize it.

Gerhardt was an employee, not on fees, as mentioned in the debate in the House, but a full-salaried employee of the Port of New York Authority. His income was taxed by the United States, and the Supreme Court held it was taxable under the present income tax law.

While in practically every case theretofore, the basis of the taxation of the salaries of individuals, or the exemptions, had been treated in more or less this fashion.

We look to the functions that are being performed. If the functions are governmental, then the immunity follows to those who perform those functions.

For example, in *Rogers* v. *Graves*, Rogers was the general counsel of the Panama Railroad Co., a New York corporation, owning property in New York State, and operating wharves and offices in New York State, Rogers living in New York State and working there.

The railroad operated steamship lines, ferries, tourist hotels, and carrying freight generally. The United States Supreme Court held

that his salary could not be taxed, as the Panama Railroad, although a New York corporation, its stock being owned entirely by the United States, it having been acquired as a part of the Panama Canal, was an integral part of the Canal, and its operation an arm of the national defense, and, therefore, all of these other operations must be regarded as incidental, and since the function performed by the Panama Railroad is a part of the functions of the national Government, the others were incidental, and the individual officers were immune from taxation.

In the *Brush case*, *Brush* v. *The Commissioner*, there was a chief engineer of the New York City water supply that was sought to be taxed, and it was held in that case that his salary was not taxable, a salary paid directly by the city of New York, and the Court said this was a function essential for the health and preservation of the people of that city.

The CHAIRMAN. Which was an adoption of the former views of the Court.

Mr. EPSTEIN. Not necessarily. The question of water supply as an operation by a municipality had been previously decided by the Supreme Court. The obligations of the municipality, the Court had sustained in tort obligations, and the Supreme Court, in the *Brush case*, made clear that distinction. Two of the judges dissented.

Senator MILLER. The *Brush case* merely held for the first time that the function of the water department was governmental?

Mr. EPSTEIN. My point is not that, but the functions being definitely those of the performance of the governmental function.

Senator MILLER. Then followed that question as to whether the functions of a water company were governmental?

Mr. EPSTEIN. That is true.

But when you come to the *Port Authority case*, the United States Government and the port authority counsel and the State of New York, in their briefs and in their arguments before the lower courts and in their arguments before the Supreme Court, deal solely with the function itself, and counsel for the Government admitted before the Court, as the brief shows, that if the functions were regarded as governmental, it would follow that the exemption of Gerhardt's salary would be sustained.

The opinion completely abandoned the use of the functional test, and it takes two tests with regard to the United States, and it says:

1. Is the act of Congress an act which Congress has the power to enact?

2. Since Congress has the power to enact the statute, if it did have, did the Congress intend to grant an exemption as to the States?

Is the function being performed by the individual one which is necessary to the preservation of the State as a State?

Is the burden so speculative and indirect that it does not affect the function itself, leaving open entirely the question of the taxation of those who perform directly governmental functions, such as the governor or the legislators or others, leaving completely aside the direct statements and leaving no doubt as to the point of view of the court that the rule of the *Pollock case*, and the rule as to the immunity of the States and the municipalities from taxation of their securities remains substantially as it did before.

Mr. Justice Stone, for example, said:

> Just what instrumentalities of either a State or the Federal Government are exempt from taxation by the other cannot be stated in terms of universal application. But it has repeatedly held that those agencies through which either government immediately exercises its sovereign powers are immune from the taxing power of the other.

Now, Mr. Justice Stone—and someone has said that sometimes in the decisions of the Supreme Court or of other courts, there is much more dynamite in them than in the body of the decision, in which the statement is made that the people are represented in Congress, and, therefore, they can protect themselves against the action of Congress, omitting entirely Marshall's warning that you must preserve that balance between local and national governments, and omitting also a discussion of the essential factors preserving an equal status of the National Government with the State governments.

We submit to the committee that as to the National Government and as to the Congress, one Congress cannot bind another, and the power to legislate on matters which pertain to the fundamentals of State immunity was never intended, and that there is a danger to which the State cannot undertake to surrender.

The representatives of one State have no veto power in Congress and the danger of group blocs forming, of one section of the country against another, and the minorities have no protection whatever.

The Federal Government acts by a majority of the Congress, and not by unanimous vote, and the majority of the States would have it in their power, unless the Supreme Court could, by interpretation of the Constitution, prevent, victimize the minority, and we submit that the victimization of the minority is not sound constitutional law.

I have reviewed the opinions of the Supreme Court in which they have uniformly held that the interest on these bonds is immune from taxation.

I would like to call attention to the fact that the States are not taking a position on the question of the taxation of salaries. We wish to make it clear that there is involved in that a constitutional issue which may possibly be necessary to become a part of this discussion.

In regard to the retroactive feature, there is no reason to discuss that.

The CHAIRMAN. Do you think there is some difference between the right of Congress to impose a tax on the salaries—on the salary of the Governor of New York—and the right of Congress to impose a tax on the income from securities?

Mr. EPSTEIN. Let me give you my analysis on that, Senator, if you please.

The taxation of salaries may not impede the actual operation of the Government, and, as has been pointed out by Mr. Justice Stone, it does not follow that the taxation of the salary of an official would mean the nonperformance of his services, and it does not mean that the State would lose revenues, or that you would have to increase his salary.

The taxation of interest on bonds takes an entirely different turn, and has an effect on the borrowing power of the State. So, you have there a basis for distinction.

But, even in the dissenting opinion of Mr. Justice Roberts in the *Brush case*, and the reasoning, which appears now to be the opinion of the majority, in the *Gerhardt case*, would indicate, as the Justice states, an analogue in private industry in that, in that type of industry being performed, by individuals that takes them within the scope of the Federal income tax, and the question of where you have no analogue, but where you have the officer performing a direct function of government.

Then you come to the principle of *Dobbins* v. *Commissioner*, and *Collector* v. *Day*. In the *Dobbins case* you had the captain of a revenue cutter, and it was held that the county could not tax his salary, for he was an agent performing the functions of the Government.

In *Collector* v. *Day*, there is a converse case. There is no evidence that the court, even now, would go behind Mr. Justice Roberts, where he states that you find an analogue.

You have the basic constitutional question in the case of the governor as to the performance of governmental functions, just as you have in the occupation of a policeman or a general of the Army who is going forth to war.

We therefore say, and I would like to draw my remarks to a conclusion, because I have gone beyond my time, that we have two basic principles of jurisprudence here involved:

1. That there be some reasonable predictability of the law itself, whether it be essential to orderly society. The Department of Justice and the Treasury desire to overthrow, by doubtful statutes, decisions of uniform effect, giving the exact meaning of constitutional provisions and of legislative provisions, which the court has said is the basis on which an orderly society should rest, in applying the constitutional provisions, and I might add, by injecting here in this recent dispute as to the meaning of the words "advice and consent of the Senate,"——

The CHAIRMAN. You are getting on dangerous territory, there, now.

Mr. EPSTEIN. I am merely using it as a parallel. Where you have the word "advice" used with the word "recommend," and where you have "advice and consent" meaning "recommendation and consent," and you have, from George Washington's time down, an uninterrupted practice and application, it may be, very well, an important reason for applying that particular method of construction to what has been an accepted meaning of the practice of a constitutional provision.

We have a governmental system in which it is absolutely important that the States and the National Government retain their proper respect for each other. They are both operating under a constitution, and they should both operate under a constitution without distorting it, not only from its original meaning but from its meaning today, if we are to preserve our form of government.

It is said, when the constitutional delegates were meeting at Philadelphia, the people threw dirt on the cobblestones around the hall so that they might be understood in their debates, and they came out of there with the Constitution under which we have lived and which has been interpreted uniformly by the Court on the particular issues we have here.

I am reminded of the story of the Russian peasant and his son going to market, trudging along a dusty road.

The father saw lying in the road an old horseshoe and wanted to pick it up, and asked his son to do it, and his son, having a load on

his back, did not want to bend down. But the father bent down and picked up the horseshoe and stuck it in his girdle.

About 3 miles farther on, he came to a farmer that had a horse, and he traded his horseshoe for a bag of cherries, and he hobbled on, and as he went along munching the cherries he would drop one, and his son would bend down and pick it up and brush it off and eat it.

That happened two or three times, until they were exhausted, and then the father turned to his son and said, "Son, you would not bend down once to get a whole bag of cherries." And the son said, "It takes a wise man to see in a horseshoe a fresh bag of cherries."

We believe that there are those left who still have occasion to read Genesis, and some still believe in it. I still believe in the value of preserving the Constitution and the constitutional principles, and preserve it from radical changes which may be inconsistent with our orderly lives, and, as I said, the preservation of the integrity of the State is fundamental in our constitutional system.

I have just one word that I would like to add, because, as I understand, Senator Miller yesterday raised some question with regard to the due-process clause on outstanding State and municipal bonds. I cannot quite see how that question can arise, because there is no contract in which the Federal Government is bound, when the contract involved is the third contract with its bondholders, the State's contract with its bondholders.

The fourteenth amendment has no application, and the fifth amendment in no way binds the Federal Government to a contract between the State and its bondholders to pay the bondholders a certain amount of money.

So I cannot see where there is any protection in the fifth amendment on outstanding bond issues, if the power is given to tax future issues. Do you follow my reasoning?

Senator MILLER. Yes.

Mr. EPSTEIN. I meant merely to mention that because the question was raised.

The State can in no way make a contract which can affect the Federal Government by including back taxes.

Senator MILLER. I understand. That is necessarily true as to future issues.

Mr. EPSTEIN. That is protection against the presently outstanding issues, for it is only a contract between the State and the individual.

Senator MILLER. I believe there is something in what you say; but I also believe there is something back in my mind about taxing outstanding issues.

Mr. EPSTEIN. Naturally, I would like to persuade you; but I would like for you to give careful consideration to what I said.

May I say that we are extremely grateful for the opportunity that you have given us to present our case here.

Other attorneys general will offer their individual views on several aspects of the question.

I have covered it rather hastily, but I tried to give a full presentation of the matter.

The CHAIRMAN. We have listened with a great deal of interest to your presentation, and we thank you, Mr. Epstein.

We will now hear from Mr. Raymond J. Kelly, corporation counsel of the city of Detroit.

STATEMENT OF HON. RAYMOND J. KELLY, CORPORATION COUNSEL, CITY OF DETROIT, AS CHAIRMAN OF THE SPECIAL INSTITUTE COMMITTEE ON TAXATION IMMUNITIES FOR THE NATIONAL INSTITUTE OF MUNICIPAL LAW OFFICERS

Mr. KELLY. Mr. Chairman and gentlemen of the committee: I am appearing before this committee as corporation counsel of the city of Detroit, and as chairman of the special committee on tax immunities of the National Institute of Municipal Law Officers.

The National Institute of Municipal Law Officers is an organization of all city attorneys, representing cities over 30,000 in population and quite a number of attorneys representing cities having a smaller population. The organization is supported entirely by the public funds of cities. Barnet Hodes, corporation counsel of the city of Chicago and president of the National Institute of Municipal Law Officers, has appointed the following city attorneys to serve with me on this special committee: Harry Scalo, city attorney of Mobile, Ala.; Josepy Sharfsin, city solicitor of Philadelphia, Pa.; Austin Miller, city attorney of Jacksonville, Fla., who is represented here today by Gov. Hutchinson, city solicitor of Jacksonville, Fla.; Ray Chesebro, city attorney of Los Angeles, Calif.; A. C. Van Soelen, corporation counsel of Seattle, Wash.; Charles F. Lynch, city counsel of Paterson, N. J.; Fisher Harris, city attorney of Salt Lake City, Utah; Julian W. Bernard, city solicitor of Norristown, Pa., and Charles Z. Heskett, of Cumberland, Md.

Our affiliated organization, the United States Conference of Mayors, has offered to this committee resolutions adopted by city councils throughout the country on this taxation immunities question.

We concur in the legal brief that has just been presented, and I am not going to cover any of the testimony that has been so ably presented by Mr. Epstein, and some points that will be brought out by other witnesses.

The legal brief just presented by Solicitor General Epstein was also presented on behalf of my special institute committee and the city attorneys we represent.

After the President's message of last April 25, 1938, the institute received some telegrams and statements from city attorneys stating their views on the President's proposal. I ask that these statements be incorporated in the record at this point as part of my testimony. I do also tender for the record the answers of city attorneys to a questionnaire which was sent out, under directions of a resolution adopted at the last national convention of city attorneys which was held in Washington, D. C., December 5, 1938, through December 7, 1938, to allow them to express their views on this important matter. I ask that these answers be incorporated in this record as part of my testimony at this point.

I ask leave to have these statements presented in the record.

The CHAIRMAN. They will be received.

Mr. KELLY. I also want to tender the answers to the questionnaires.

The CHAIRMAN. They also will be received.

(The statements referred to by Mr. Kelly are as follows:)

The following are examples of replies received by the National Institute of Municipal Law Officers in April 1938 when an announcement was sent out to

municipalities that the President was proposing taxation of income from municipal bonds and salaries.

[From William H. Emerson, corporation counsel, Rochester, N. Y.]

Your letter of April 16th in reference to congressional action on taxing of municipal bonds received. The city of Rochester is, of course, very much opposed to any such legislation and hope you will do anything in your power to prevent it. If necessary, or if you recommend it, probably someone from this office would attend a congressional hearing.

[From Walter L. Dickey, city solicitor, Portsmouth, Ohio]

I am in receipt of your letter relative to proposal of the President to secure the passage by Congress of a law taxing the income of State and municipal bonds.

I am wiring my Congressman, James G. Polk, to oppose the bill and to further contact you in the matter. A copy of the wire is enclosed.

This seems to be a means or method of taxing individuals indirectly in order that they may not feel the sting of taxation. A tax on municipal or State bonds would be reflected in the interest rate of such bonds and would annually add to our debt charge, and bonds inside would increase our debt charge and further limit our levy for operating expenses which is now too low for satisfactory operation.

I believe the measure should be opposed, and any assistance that we can render further than a request to our Congressman to oppose the bill will be given by the city of Portsmouth.

[From Hugh S. Gamble, city attorney, Sioux Falls, S. Dak. (telegram)]

Sioux Falls and I feel confident the entire State are unalterably opposed to any laws enacted by Congress taxing the income on municipal bonds and obligations. This tax would raise interest rates to a point where their sale would be almost prohibitive and in many instances bankrupt several of the smaller towns and cities.

[From H. W. Snodgrass, acting city solicitor, City Hall, Springfield, Ohio (telegram)]

Proposed taxation of bonds will be detrimental to our contemplated $135,000 issue of Works Progress Administration street improvement bonds. Unalterably opposed to passage of any such legislation which will prevent cities from carrying on work under Works Progress Administration and other city financing.

[From Harry Knudsen, superintendent, department of accounts and finances, Omaha, Nebr. (telegram)]

This department protesting strongly passage of new law placing municipal bonds on par with taxable commercial bonds. Eliminating tax exemption for municipal bonds will add new burden for additional interest and practically stop municipal improvement activities and in many cases will bankrupt cities where improvements are solely financed by bonds. We urge you to use your influence and voice protest against such reasonable bill.

[From Perry D. Wells, attorney and counsellor, Elgin, Ill.]

The proposal to tax income of State and municipal bonds and obligations will be the "last straw" so far as municipal financing is concerned.

In Illinois local municipal governments have had their tax income decreased through the device of reducing assessed valuation of taxable properties. In addition, by means of bond financing the local governments have cooperated with the Federal Government in financing improvement projects. While many of these projects are of undoubted value, economic administration under normal circumstances would have postponed such construction until more favorable times.

The issuing of bonds to supplement Federal funds in these improvements has increased the bonded indebtedness of local administrations almost to the danger point. The taxing of the income from any further bond issues will seriously injure if not destroy the market for municipal bonds.

If this proposal is enacted into law, the cities will no longer be able to join with the Federal Government in public works through the private sales of their securi-

ties. The burden will either fall entirely upon the Federal Government for such financing or else public improvements by local governments will cease.

[*From Lilias F. Evans, city comptroller, Highland Park, Mich.*]

Replying to your letter of April 16, 1938, addressed to Mr. Earl B. Young, city attorney, regarding a law taxing the income of State and municipal bonds and obligations. Mr. Young asked me to answer.

The city of Highland Park has investments in its funds:

Sinking fund	$1,403,000.51
Fire and police pension	378,125.99
Water fund	119,000.00
Fire insurance	18,000.00

In which are bonds of other municipalities, counties, school districts, etc.

[*From C. V. Jones, city attorney, Durham, N. C.*]

For your information I some time ago wrote letters to the two Senators from North Carolina, and requested that they use their vote and influence against this measure.

[*From Frank P. Cummings, city solicitor, Williamsport, Pa.*]

In response to your letter, I wired our Congressman, Hon. Robert F. Rich, and each of our United States Senators, Hon. Joseph F. Guffy and Hon. James J. Davis, the following telegram: "The city of Williamsport, Pa., opposes passage of the pending bill taxing income on municipal bonds and obligations and urge you to vote against its passage."

[*From Joseph Sharfsin, city solicitor, Philadelphia, Pa.*]

This will acknowledge receipt of yours of April 16, 1938, informing me of a proposed action to secure Federal legislation taxing income of State and municipal bonds and obligations.

I am, of course, very much opposed to any such proposal. If such legislation were enacted and held constitutional it would impose a tremendous handicap on the municipalities and would not only seriously interfere with the market for future issues of municipal bonds, but in the case of past issues, in which the municipality agreed to bear the tax payments, it would impose a burden on the municipality which was not anticipated at the time of issue.

[From Alfred Clum, director of law, Cleveland, Ohio]

Answering your letter of April 16, 1938, relative to taxes imposed by the Federal Government on State and municipal bonds, I have to say that I have no brief but my assistant has hurriedly collected the following citations denying the right to impose such tax on State and municipal bonds: 26 R. C. L. 84, 85.

Municipal Bonds: 121 U. S. 138.

Obligations of State: 26 A. L. R. 513 (Neb.) and note; Cf. 269 U. S. 514; 277 U. S. 508; 279 U. S. 620; 282 U. S. 216; 283 U. S. 279; 283 U. S. 570; 285 U. S. 283, 282 U. S. 379.

[From Fred E. Steele, city attorney, La Crosse, Wis.]

The committees of the council have instructed me as city attorney to state that the common council of the city of La Crosse is not opposed to the taxation of Federal bonds but on the contrary recommends that the Federal Government repeal the tax exemption of all Federal bonds.

[From Harry E. Weinberg, city attorney, Duluth, Minn.]

In reply to your letter dated April 16, 1938, calling attention to the fact that the President of the United States is likely to ask Congress for an act imposing a tax on State and municipal bonds, I beg leave to enclose herewith a certified copy of a resolution that the city council of this city approved on December 30, 1937.

As you will note from this resolution, the city council has already gone on record by filing its protest with the Minnesota Senators and Congressmen against the type of legislation to which you have called attention. (The resolution mentioned was tendered for this record by our affiliated organization, the United States Conference of Mayors, as part of Mayor La Guardia's testimony.)

A BALLOT WAS SENT OUT TO CITY ATTORNEYS CONTAINING THE FOLLOWING FIVE QUESTIONS

1. Are you in favor of removal of all tax immunities on municipal bonds?
2. Are you in favor of removal of tax immunities of salaries of municipal employees?
3. Are you in favor of legislation allowing reciprocal taxation of income from municipal bonds?
4. Are you in favor of legislation allowing reciprocal taxation of municipal, State, and Federal salaries?
5. Is reciprocal legislation practical? (Please attach a memorandum of any practical reasons why such legislation would work an undue hardship on your city—we have rather complete legal authorities.)

Attached hereto are the answers of city attorneys forwarded to the National Institute of Municipal Law Officers in reply to the questions.

TABULATION OF ANSWERS ON TAXATION IMMUNITIES BALLOT SENT OUT BY NATIONAL INSTITUTE OF MUNICIPAL LAW OFFICERS

The following city attorneys (excluding 6) answered all the five questions "No":

[Numbers indicate explanations which follow this list]

	Harold E. Hanson	Madison, Wis.
	Herbert S. Beane	Dayton, Ohio.
(1)	Christian M. Ozias	Fresno, Calif.
(2)	Aubrey N. Irwin	Glendale, Calif.
(3)	John W. McConnelong	St. Paul, Minn.
(4)	Charles Z. Heskett	Cumberland, Md.
	Fisher Harris	Salt Lake City, Utah.
(5)	Ray L. Chesebro	Los Angeles, Calif.
	Walter Ellis	East Orange, N. J.
(6)	Walter J. Mattison	Milwaukee, Wis.
	Alfred Anderson	Norfolk, Va.
	A. L. Love	Austin, Tex.
	Ralph Oman	Topeka, Kans.
(8)	Harold J. Eckroate	Barberton, Ohio.
(9)	A. C. Van Soelen	Seattle, Wash.
(10)	Malcolm Lindsey	Denver, Colo.
(11)	Ralph H. Egan	Newburgh, N. Y.
(12)	Harry Seale	Mobile, Ala.
(13)	Harold F. Thuenen	Davenport, Iowa.
	W. F. Dickey	Portsmouth, Ohio.
(14)	John L. Goodwyn	Montgomery, Ala.
(15)	John T. Barbrick	Pueblo, Colo.
	Fred. A. Garlepy	La Grange, Ill.
(16)	H. P. Kucera	Dallas, Tex.
(17)	W. J. Carey	Decatur, Ill.
	Richard M. O'Connell	Bloomington, Ill.
(18)	Wm. A. Minihan	Lexington, Ky.
	James F. X. O'Brien	Newark, N. J.
	Joseph Sharfsin	Philadelphia, Pa.
	George E. Hartshorn	Cleveland Heights, Ohio.
(19)	Charles F. Lynch	Paterson, N. J.
(20)	Austin Miller	Jacksonville, Fla.
(21)	Julian W. Barnard	Borough of Norristown, Pa.
	William R. Condit	White Plains, N. Y.
	Ralph Rouse	Danville, Ill.
	W. J. Wynn	Birmingham, Ala.
	J. Harvey Robillard	Miami Beach, Fla.
(22)	Ed. J. McKinley, Jr.	Little Rock, Ark.
	Proctor R. Perkins	Council Bluffs, Iowa.
(23)	Alton H. Skinner	Kansas City, Kans.
(24)	Donald T. Hines	Cedar Rapids, Iowa.
	B. E. Brower	Jackson, Mich.
(25)	Raymond J. Kelly	Detroit, Mich.
	James C. Holbrook	Joliet, Ill.

TABULATION OF ANSWERS ON TAXATION IMMUNITIES BALLOT SENT OUT BY NATIONAL INSTITUTE OF MUNICIPAL LAW OFFICERS—Continued

(26)	Ganson Taggart	Grand Rapids, Mich.
	Ralph P. Rich	Covington, Ky.
(27)	J. Watties Waring	Charleston, S. C.
	James C. Tormey	Syracuse, N. Y.
	Perry D. Wells	Elgin, Ill.
(28)	Philip H. Hill	Charleston, W. Va.
	Arlen T. St. Louis	Schenectady, N. Y.
	Lawrence R. Ormiston	Watertown, N. Y.
	H. C. Wilson	Greensboro, N. C.
	F. T. Van Liew	Des Moines, Iowa.
(29)	C. E. Hunter	Roanoke, Va.

EXPLANATIONS FROM THOSE WHO ANSWERED "NO" TO ALL FIVE QUESTIONS

(1) Christian M. Ozias; Fresno, Calif.: The city of Fresno, Calif., is taking reasonably good care of its financial problems. Any additional burdens from without the city would deprive it of the benefits secured by local control of municipal income and out go. Methods of Federal taxation should be carefully and strictly circumscribed.

(2) Aubrey N. Irwin; Glendale, Calif: Did not answer No. 5, i. e., Is reciprocal legislation practical?

(3) John W. McConnelogg; St. Paul, Minn.: Memorandum attached—It appears to me that taxation of salaries received from municipalities, as well as the taxation of income derived from municipal bonds, would merely add to the already staggering cost of such governments. Certainly taxation of municipal bonds would make them less attractive to the investor, and the cost to local governments would immediately increase.

As to the taxation of municipal salaries, would say that in the main the salaries of the employees of the city of St. Paul are based on the cost of living wage ordinance. In other words, we established our salaries some years ago on the basis of the then existing salaries, as compared to the cost of living, and they fluctuate, depending upon such cost of living in this area. It seems only reasonable that in the event such employees were required to pay an income tax on their salaries, the city would undoubtedly be called upon to increase their base pay to compensate for such tax.

This, of all times, seems to me to be a time when municipalities, and especially the larger cities in this country, must be given a fair chance to continue their existence. We are struggling day by day to maintain our relief costs, and nothing should be added to our cost of government which would endanger the proper care of those on relief.

(4) Charles Z. Heskett; Cumberland, Md.: *Remarks.*—The taxation of municipal bonds can do nothing but decrease their desirability as investments and the public would simply have to pay higher interest rates equal to the amount of money that would be raised by the taxes. In principle the proposal is like paying yourself rent for a house you own and live in. I am opposed to this extension of the taxing power, and also taxation of municipal salaries (not because of the small cost to me) but because it is another long step in the complete federalization of the Nation.

(5) Ray L. Chesebro; Los Angeles, Calif.: Copies of enclosed resolutions of parties interested here were yesterday mailed to our Senators and Representatives, and copy of our letter. (Attached were a copy of Mr. Chesebro's letter to Hiram W. Johnson, Senator, and copies of Resolution of the League of California Municipalities Opposing Federal Policy on Income Taxation, Resolution Relating to Federal Taxation, Los Angeles Fire and Police Protective League Resolution, All City Employees' Association of Los Angeles, California, Resolution, Resolution by Executive Committee of the Civil Service Protective League, and a Resolution, No. 37, by Los Angeles Water and Power Employees' Association of the City of Los Angeles—these resolutions were tendered for this record by Mayor La Guardia and Mr. Fernhoff as part of their testimony.)

(6) Walter J. Mattison; Milwaukee, Wis. (letter): I am returning my ballot on the question of tax immunities on municipal bonds and municipal salaries and as you will see my answer to the questions as to whether these immunities should be removed is "no."

In the first place, on the question of salaries of municipal employees we find that there are but 21 States in the Union where income taxes prevail and the so-called waiving of immunities become effective only in those 21 States.

Then it has been our understanding that municipal salaries are fixed with a view of the fact that they are exempt from Federal income taxes. If this immunity from taxes is removed, it will simply mean that the various cities will be compelled to add the amount of Federal taxes to prevailing salaries in order to put the municipal employees on the same basis as private employees in like work.

As far as municipal bonds are concerned, the city of Milwaukee will have no funded debt after 1943, so this problem does not vitally concern us. However, the fact that our municipal bonds are exempt from Federal taxes has enabled the city to borrow money at an interest rate that reflects the amount of Federal income-tax exemption. I can see no particular reason why these tax immunities should be abolished.

(No. 5 not answered on ballot.)

(8) Harold J. Eckroate; Barberton, Ohio: Excessive cost of collection, jurisdictional conflicts arising from nature of public employment. Widespread differences of rates of pay due solely to local tax revenues would effect unequal operation of such laws. (The foregoing in explanation of "No" to No. 5.)

(9) A. C. Van Soden; Seattle, Wash.: Effect of municipal public utility, activity particularly in light and power field, in this city is good, has resulted in low rates. Taxation of bonds would retard further development by city.

(10) Malcolm Lindsey; Denver, Col.: Did not answer No. 5.

(11) Ralph H. Egan; Newburgh, N. Y.: Did not answer No. 5.

(12) Harry Seale; Mobile, Ala. (letter): I have just received the ballot on the question of the favoring of tax immunity vel non on municipal securities and salaries of municipal employees. I am very much surprised to learn that any member of the institute would recommend the removal of immunities, especially at a time when the central Government is extending its powers so rapidly with the certain ultimate effect of destroying States' rights and individual liberties. "Government from a distance is tyranny."

One of the surest ways to enable the central Government to whip the States and their political subdivisions into line with the Federal policy is to give the Federal Government the right to levy taxes on State securities. By the imposition of a heavy tax the Federal Government can deprive a municipality of its ability to market its bonds at legally acceptable bids and thereby prevent public improvements, refinancing, etc.

The Federal Government at this time depends on constant change of policies and theories in order to detract the public mind from major issues, and it is perhaps for that reason that some of our city attorneys have lost sight of the grave dangers involved in the proposal under consideration and feel that it is safe to depart from the wisdom of our forefathers. They would readily destroy our dual form of government and our system of checks and balances on the theory that we are no longer living in horse and buggy days. I am afraid that these same gentlemen would also propose to vote for a change in or an amendment to the Ten Commandments on the theory that they were adapted to conditions existing during Moses' sojourn on the earth. Good principles of government (dual form of government for large and diversified areas, checks and balances) are just as applicable to highly civilized peoples as to groups in the lower stages of development, just as other principles governing human conduct (the Ten Commandments) are equally beneficial to all stages of civilization.

I certainly hope that the institute will use every effort to defeat the proposal.

(Also attached copy of letter to Senator Pankhead re above; and note that similar letters were sent to each Senator and Congressman).

(13) Harold F. Thuenen; Davenport, Iowa: Re No. 5—it is merely an entering wedge for the ultimate break-down of constitutional limitations on Federal and State authority.

(14) John L. Goolwyn; Montgomery, Ala.: Mayor W. A. Gunter has already communicated his views in line with above to the Senators and Representatives from Alabama.

(15) John T. Barbrick; Pueblo, Colo.: The power to tax is the power to destroy.

(16) H. P. Kucera; Dallas, Tex. (letter): I am returning herewith my ballot on taxation immunities.

In connection with question No. 5 you are asking if reciprocal legislation is practical. It is my firm belief that reciprocal legislation of this sort is impractical

for several reasons. In the first place, it would take an action of Congress to permit the taxation of Federal securities and salaries of Federal employees. After that has been obtained it would be necessary for each of the States to enact legislation to take advantage of this situation. There being 48 States, 48 different legislatures would have to act on this matter, and since each State has different tax laws radical discrimination would necessarily result either against one or the other, that is, either the Federal employee or the State, city, or county employee. In Texas we do not have any State income tax. Assuming, therefore, that Congress should pass a law authorizing the taxation of Federal salaries on the income-tax basis, then it would be necessary for the State of Texas to enact legislation of a general nature to take advantage of this situation and thus impose an entirely new form of taxation upon its people.

Still another impractical situation arises from the fact that reciprocal legislation to my mind would be a further surrender of State's rights to the Federal Government. In other words, Congress acting on the subject first would be in a position to coerce the States into legislation which would be largely dictated by the Congress.

States and cities have absolutely nothing to gain by the proposal because obviously there are more State, county, and city employees than there are Federal employees in the State whose salaries can be reached by this form of taxation. Since cities in Texas depend largely for their source of revenue on direct taxation on the ad valorem basis, it would result in placing additional burden of taxation on real estate owners and home owners because salaries would inevitably have to be raised in order to offset the loss through income-tax payments to two authorities, that is, to the Federal Government and to the State Government.

Again, the imposition of a tax on State or municipal securities under such reciprocal plan would have the direct result of raising the taxes of the taxpayers on future issues of bonds. This necessarily follows because under the Texas Constitution bonds of counties or cities are direct obligations and are dischargeable through ad valorem taxation on real estate and personal property.

The foregoing, in the main, covers my thoughts on the subject.

(17) W. J. Carey; Decatur, Ill.: Preserve at all costs the dual form of government. The States have reserved to themselves complete sovereignty and have delegated to the Central Government only certain powers. The power to tax the several States, their bonds, incomes, officers, employees, instrumentalities, and subdivisions have never been granted. If that ever occurs sovereignty of States will be destroyed.

The cause of our Revolutionary War was founded on the declaration of our Colonies that "Taxation without representation is tyranny."

"Taxation without our consent cannot be tolerated."

Reciprocal taxation is unfair to local subdivisions of State.

1. Increase costs of financing, thereby decreasing net income.

2. Increases taxes on local taxpayers within the subdivisions of State government.

3. Once admit the right to tax by Federal Government of States and their subdivisions, then States sovereignty is destroyed.

4. The States cannot tax the Federal Government without their consent, even though the Federal Government should tax the States. Consent may be withdrawn any time.

5. Added cost of financing borne by local taxpayers of State subdivision will not be replaced to said local taxpayers by any reciprocal taxes on Federal finances since such reciprocal taxes would go to the State.

6. Such added taxes for municipal financing would have to be borne largely by local real estate in States where there is no tax permitted on income.

(18) William A. Minihan; Lexington, Ky.: No answer to No. 5.

(19) Charles F. Lynch; Paterson, N. J.: No answer to No. 5.

(20) Austin Miller; Jacksonville, Fla. (statement on attached sheet): Taxation by the Federal Government of municipal securities and the salaries of municipal officers is, in my opinion, both impractical and would work extreme hardships upon municipalities, among the reasons being the following:

(1) Because of the recent depressions many municipalities are finding it necessary to refund their bonded debt. Any change in the status of municipal bonds would deter this refunding. The fact that these refunding bonds are tax free is one of the greatest incentives for the holders of the municipal bonds to cooperate with the municipalities in their refunding program.

(2) Municipal salaries are in the main below those of persons doing similar work in private employment. In fixing salaries the authority charged with this duty

has taken into consideration the fact that these municipal salaries are not taxable. For public and political reasons the authority charged with fixing salaries, generally either the State legislature or town council or commission, feels that it safely cannot and therefore will not increase the salaries of municipal officers in the event they do become taxable. Even, however, should they be raised, the burden would fall back upon the taxpayers.

(3) Reciprocal taxation is not practical in that cities, counties, and even States are not equipped to enforce taxation against Federal securities. Reciprocal taxation would mean that the Federal Government would get its full share of taxes imposed by it upon municipal securities and salaries in that its Income Tax Department is equipped to enforce this taxation. The State taxing units, being not so equipped and having no exterritorial jurisdiction, would be unable to collect the taxes due them and therefore a reciprocal taxation would be reciprocal in name only.

(4) Reciprocal taxation would also in my opinion be extremely injurious to the country as a whole in that it would cause a rivalry between governmental units to see which could tax the other the most. It would certainly be contrary to the public policy of the country as a whole and would work much more injury than effect good.

(21) Julian W. Barnard, borough of Norristown, Pa.: I am very definitely opposed to the removal immunities on municipal obligations for the very obvious reason that if the Federal Government places a tax on the obligations of Norristown it only compels Norristown to pass the tax on to the taxpayers of Norristown.

All of our presently existing borough bonds carry tax free covenants by which the borough obligates itself to pay any taxes that may be imposed upon the obligation.

If these obligations did not carry tax free covenants they would not be so readily saleable, would not bring such an attractive premium and would not be saleable for such a very low interest rate. There again the borough would have to make up this tax by exacting it from the taxpayers of the borough either in increased interest rates, or in the loss of principal premium on the sale of the obligations or both. It stands to reason people are not going to pay 104 or 105 for a bond yielding 1¾ or 2 percent, or even 3 percent interest if they have to expend a large proportion of their interest yield in paying taxation on the investment. Any way you work it the tax would be passed from those who can best afford to pay to those who can least afford to pay-- the small property owners of the borough.

I am not in favor of the removal of tax immunities on the salary of municipal employees for the very obvious reason that this again would be passing the tax on to the taxpayers of the borough.

If any of the employees of the borough of Norristown were, in the opinion of the borough council, receiving too much money they would now have their salaries reduced. Therefore, and quite obviously if the salaries now payable to the borough employees were reduced by Federal taxation, the borough would have to make this up in the form of salary increase which again would come out of taxation levied upon the taxpayers, property owners of the borough. Furthermore, it is an indirect method of taxation compelling the borough to levy tax money and turn it over indirectly to the Federal Government. In my estimation all taxes ought to be direct and visible. The taxpayer ought to know where his money is going. When the taxpayer pays his tax money to the borough he thinks it is going to the borough. It is not fair, or in my estimation honest, to have that diverted to the Federal or State Government. The Federal or State Government ought to be required to raise its own tax money.

The idea of reciprocal taxation of income from municipal bonds and reciprocal taxation of State and Federal and municipal salaries is in my estimation foolish, because presumably if the Federal Government pays an employee a salary, part of which is immediately diverted to the Treasury of a municipality, then the Federal Government has raised taxes, paid it out in salaries and had part of the Federal Government taxes diverted into the municipal treasury. Presumably the Federal Government would have to raise increased taxes in order to compensate for the loss of salaries to the Federal employees. The municipality counters by levying taxes upon the salary and obligations of Federal Government and you are running around in circles and getting nowhere. In addition to that it would be bound to be unfair.

Reciprocal legislation would mean nothing to the borough of Norristown since the borough of Norristown is not permitted, under Pennsylvania State constitution law, to levy income taxes or personal property taxes. We get our revenues exclusively out of real estate taxes.

(22) Ed. J. McKinley, Jr.; Little Rock, Ark.: No answer to No. 5.

(23) Alton H. Skinner; Kansas City, Kans. (letter attached): This acknowledges receipt of your ballot on Taxation Immunities. I will make a short comment on the answers I make to each of the five questions submitted.

1. Are you in favor * * *. ?——No.

This for the reason: First, that all general obligation bonds are paid from taxation. Municipalities are restricted by the constitution and laws of their respective States and the charters of their cities, in the matter of borrowing money.

The only purpose for issuing bonds in advance of the collection of the taxes and special assessments necessary to pay the same, is that the public improvement constructed out of the proceeds of the bonds may be constructed immediately and by its service render such additional service to the community as to practically earn its cost during the period necessary to retire the bonds. Were it not that the municipal bonds had tax immunities, municipalities would not have been able to participate in the Federal program for work relief during the not yet ended period of depression. Participation would have amounted to such an increase in taxes that the people would not have supported it.

2. Are you in favor of * * *. ?——No.

In Kansas, the law requires in all municipalities, that before any person can be appointed to a public place, the position must be created and the salary and term of office fixed. The employees working for the public, are specifically excluded from the benefits of the Social Security Act. Employees working for the public are subject constantly to the risk of losing their jobs without compensation, due to changes in the political control.

Officers and employees in public office are constantly subject to the drain of contributions because of the fact that they are in public office, and this contribution demand costs more than the taxes that might be levied already. The salaries as ordinarily fixed in public positions, is less than the current salaries paid in private industries in most cases for similar work and responsibility.

3. Are you in favor of * * * ?——No.

For the reason that municipal bonds are negotiable. They call for a certain sum of money to be paid. They are ordinarily remitted and collected through agency banks, and in the States where they are issued, coupons which are due and payable are ordinarily subject to be received for taxes, and it would be absolutely impracticable to collect the same other than by the usual form of income tax now in use.

4. Are you in favor * * * ?——No. (No comment.)

5. Is reciprocal legislation practical?——No.

The whole basis of this scheme of suggested reciprocal legislation overlooks this, to me, essential point: viz: That the power of taxing is the power to destroy. Taxation such as is proposed, would be taxation by the Federal Government of municipal governments. I believe it to be fundamental that local government should be administered by local officials. All source of power is in the people, and if local officials do not render proper service, the people have abundant authority and power to change them as often as they require, under the law fixing limited periods of office, and calling for public elections.

The whole scheme of reciprocal legislation of the kind suggested in the questions is to take from the people the power of government, including local government, by the power of taxation, and to vest it in bureaus and authorities distant from the point of local government, and with people and persons who are not affected by the specific rules adopted. It is likewise based upon the mistaken theory that the people are not capable of self-government, even in their local communities, and that persons can administer such local government who are not even residents of the community that is to be governed. Such government would be based upon rules and regulations having the effect of law.

In a long experience in municipal affairs, I have discovered that each city, town and village, county and township, has its own peculiar problems and in solving those problems the people resident in the community should be consulted, and they are capable of meeting the situation in a manner that best serves the local community. Each and every attempt to destroy the independence of local government and to take from the people resident in the local community, is a step backward, and any person who advocates the same does not believe in either a democratic or representative form of government.

Personally, I am absolutely opposed to such an infringemet of the rights of the people governed.

(24) Donald T. Hines; Cedar Rapids, Iowa (letter attached): Enclosed find ballot on taxation immunities. You will note that every question has been answered in the negative.

We take the position that tax on municipal bonds, or bonds of the State of Iowa, by the Federal Government is unconsitutional unless permission from the State is first obtained. But assuming for the sake of this discussion that such taxation is constitutional, we are still opposed to the tax on municipal bonds, or on the salaries of municipal employees.

It is our position that a reciprocal tax on Federal bonds and the salaries of Federal employees will be of no benefit whatever to the city of Cedar Rapids as a municipality of the State of Iowa. Such a reciprocal tax, if affected, would be given to the State as an increased source of revenue and under the Iowa law there is no method by which this could be reallocated to the municipalities as an off-set against additional Federal taxes they would have to pay on their municipal bonds and the salaries of their employees. In other words, the city of Cedar Rapids and the taxpayers of said city would be required to carry the burden for this increased taxation. It might not be a direct burden but certainly in the end the taxpayers would be forced to pay through an increased revenue or through the medium of a higher premium on the municipal bonds they might sell.

Before any city in the State of Iowa, in my opinion, would be favorable to said taxation, even with the reciprocal clause included, there would have to be State legislation which would afford a medium through which a proportionate share of the city's burden could be reallocated through funds received by the State by the taxing of Federal bonds and the salaries of Federal employees.

I am not familiar with the legislation of other States but by and large I believe that the cities throughout the country would find themselves in the same position as the cities of the State of Iowa.

(25) Raymond J. Kelly; Detroit, Mich.: Attached newspaper clipping of letter from Mayor Richard W. Reading to the common council re tax immunities, and directly bearing on the questions asked in this ballot. (Supplemented by oral testimony before this committee.)

(26) Ganson Taggert; Grand Rapids, Mich. (attached note): As to number (5) "Is reciprocal legislation practical?" will say that in my opinion it most emphatically is not. In the first place the States cannot deal on an equality with the National Government. It is much like a contest between a small boy and a large man, the outcome of which might be delayed but would never be in doubt. In my opinion, this is why the Constitution provides, as I read it, for independence between the States and the Federal Government, so that the Federal Government cannot abuse its power. States rights are entirely wiped out, as I see it, if such legislation is attempted, and this I do not believe to be wholesome. It is further my very firm conviction that it would take a constitutional amendment, at least until the present decisions of the courts are overthrown.

(27) J. Waties Waring; Charleston, S. C.: No answer to No. 5.

(28) Philip H. Hill; Charleston, W. Va.: Added after "No" to No. 5—New York and other money centers would get all benefit. We would get very little benefit in return for investment we would lose in additional taxes necessary to pay higher rates necessarily required on bond issues subject to taxation or income taxation.

(29) C. E. Hunter; Roanoke, Va.: Note: I suggest that each city attorney present to his city council a resolution opposing any legislation of this kind proposed. Roanoke's council has adopted such a resolution and copies have been sent to Virginia's senators and representatives.

The following city attorneys answered the questions as indicated after each name (numbers indicate explanations which follow this list):

(1) Ben S. Wendelken; Colorado Springs, Colo.
1. No. 2. Yes. 3. No. 4. Yes. 5. Yes.

(2) L. E. Latourette; Portland, Oreg.:
1. No. 2. ——. 3. See (2). 4. See (2). 5. No.

Wade De Woody; Akron, Ohio:
1. No. 2. No. 3. No. 4. Yes. 5. ——.

(3) F. B. Fernhoff; Oakland, Calif.:
1. No. 2. Yes. 3. No. 4. No. 5. No.

(4) Henry S. Brainard; Cleveland, Ohio:
1. No. 2. Yes. 3. No. 4. No. 5. No.

(5) Louis L. Robert; Evansville, Ind.:
1. Yes. 2. Yes. 3. Yes. 4. Yes. 5. Yes.

Albert W. Black; Bay City, Mich.:
1. Yes. 2. Yes. 3. No. 4. No. 5. No.

W. Mayo Payson; Portland, Maine:
1. No. 2. Yes. 3. No. 4. Yes. 5. ——.

Everett H. Dudley; Fitchburg, Mass.:
1. No. 2. Yes. 3. No. 4. Yes. 5. Yes.
James E. Greene; Dearborn, Mich.:
1. No. 2. Yes. 3. No. 4. No. 5. No.
(6) Harry Parkman, Jr.; Boston, Mass.:
1. Yes. 2. Yes. 3. Yes. 4. Yes. 5. See (6).
Maxwell Nichols; Santa Barbara, Calif.:
1. Yes. 2. Yes. 3. Yes. 4. Yes. 5. ——.
(7) William H. Emerson; Rochester, N. Y.:
1. No. 2. Yes. 3. Yes. 4. Yes. 5. See (7).
(8) Archer Bowden; San Jose, Calif.:
1. No. 2. Yes. 3. No. 4. Yes. 5. See (8).
Walter E. Helmke; Fort Wayne, Ind.:
1. Yes. 2. No. 3. No. 4. Yes. 5. Yes.
Hugh S. Gamble; Sioux Falls, S. Dak.:
1. Yes. 2. No. 3. No. 4. No. 5. No.
(9) Darlington Hoopes; Reading, Pa.:
1. Yes. 2. Yes. 3. Yes. 4. Yes. 5. See (9).
Al. J. Nelson; Dubuque, Iowa:
1. No. 2. No. 3. Yes. 4. Yes. 5. Yes.
(10) Harold P. Huls; Pasadena, Calif.:
1. No. 2. No. 3. Yes. 4. Yes. 5. No.
(11) W. W. Kennerly; Knoxville, Tenn.:
1. No. 2. Yes. 3. No. 4. Yes. 5. See (11).
Firmin Michel; Camden, N. J.:
1. No. 2. Yes. 3. ——. 4. Yes. 5. ——.
(12) Paul A. Rieser; Poughkeepsie, N. Y.:
1. No. 2. Yes. 3. No. 4. Yes. 5. Yes.

(1) Ben S. Wendelken, Colorado Springs, Colo.: Answers "Yes" for No. 2 and adds: "I see no logical reason for such immunity."

(2) L. E. Latourette, Portland, Oreg.: No. 3—If any legislation is adopted it should be reciprocal; No. 4—If any legislation is adopted it should be reciprocal; No. 5 (Letter)—In answer to question No. 5 of the enclosed ballot, we are of the opinion that reciprocal legislation is not practical for the following reasons:

1. Reciprocal legislation would grant to the State the right to tax Federal incomes and Federal bond issues and the proceeds therefrom. This would not benefit the cities, as the cities on one hand would be called upon, through a higher interest rate or a lower yield, to pay the tax which would be imposed upon municipal securities by the Federal Government and would not benefit from whatever return the State enjoyed from the taxing of Federal salaries and Federal issues.

2. Federal, State, and local bond issues are largely concentrated in the financial centers and this would mean that certain of the Eastern States would be afforded revenue out of proportion to the tax upon the salaries and securities of that particular State and its subdivisions.

3. Reciprocal tax authority limited to the taxing of Federal salaries and bond issues is not sufficient if equity is to be done to States such as Oregon. The measure should go further and allow the taxing by the State and its political subdivisions of real property holdings such as the vast forest reserves, grazing reserves, wildlife refuges, as well as Government-owned buildings which now enjoy tax exemption, although the State and local government is burdened with much of the protection and other services which these properties enjoy.

Attached is a copy of a resolution adopted by the council of the city of Portland on January 19, 1939 (Res. No. 21556 attached).

(3) F. B. Fernhoff, Oakland, Calif.: Answers "Yes" for No. 2 and adds: "But only by constitutional amendment."

(4) Henry S. Brainard, Cleveland, Ohio: Answers "Yes" for No. 2 and adds: "But not retroactive"; answers "No" to No. 4 (with some doubt about it).

(5) Louis L. Robert, Evansville, Ind.: Answers "Yes" to No. 1, including Federal and State; answers "Yes" to No. 2, including Federal and State; answers "Yes" to No. 3, including Federal and State.

(6) Harry Parkman, Jr., Boston, Mass.: Answers "Yes" to No. 3, and of income from Federal bonds by States; answers No. 5, "I believe so. The opportunity should be taken to stress the place of the cities in the governmental structure and the necessity of revenue to replace any additional cost to the cities."

(7) William H. Emerson, Rochester, N. Y.: Answers "Yes" to No. 2, if reciprocal and if constant legally with immunity of municipal bonds; answers No. 5, probably not.

(8) Archer Bowden, San Jose, Calif.: Answers "Yes" to No. 2, if Federal employees pay cities a tax; answers "No" to No. 3, reciprocity not available to cities; answers "Yes" to No. 4; answers No. 5, not in case of bonds, income taxes not generally available to cities.

(9) Darlington Hoopes; Reading, Pa.: Answers No. 5 by letter, "Enclosed herewith please find ballot on taxation immunities.

"I don't know how practical reciprocal legislation will be. It certainly seems to me that it should be possible to work out some practical arrangement between the State and Federal Governments on this matter. It is certainly undesirable to permit the immunities to continue."

(10) Harold P. Huls; Pasadena, Calif.: Answers "Yes" to No. 3, if municipal bonds must be taxed; answers "Yes" to No. 4, if necessary; encloses note, "Federal income tax the same as upon a private corporation, upon the revenues of a municipality would naturally tend to increase the cost of operations of the municipality. Since the operations of the municipality are burdened upon the citizens of that community, and a large portion of the revenue is raised from taxation, this latter would, in effect, constitute a double taxation which is fundamentally wrong."

(11) W. W. Kennerly; Knoxville, Tenn.: Answers No. 5, unless present source of Knoxville's revenues is changed, Knoxville would receive little if any benefit from reciprocal taxation.

(12) Paul A. Rieser; Poughkeepsie, N. Y.: Answers No. 5 "Yes," if extended to State and Federal salaries.

The following answered by letter (except William Chanler, by telegram) instead of by ballot: (The numbers indicate their answers which follow immediately).

(1)	George P. Drury	Waltham, Mass.
(2)	Harry F. Weinberg	Duluth, Minn.
(3)	John F. Bonner	Minneapolis, Minn.
(4)	William C. Chanler	New York, N. Y.

(1) While it is somewhat late to reply to your ballot recently sent to * * *, I am sending you this reply now.

I cannot answer categorically your questionnaire, but I will endeavor to deal with the various questions as best I can in view of the fact that I am unable to give a yes or no answer to any of them.

In reply to question No. 1, I would say that I am in favor, in principle, of removing such tax immunities, but believe that the present would be an unfortunate time to do it. Cities and towns of Massachusetts, and I believe of the whole country, are carrying very heavy burdens which fall principally upon the owners of real estate. Relief of cities and towns at present is to my mind much more important than the broadening of the base of State and Federal Government taxation. The removal of municipal exemptions would help only the State and Federal taxes and would make it harder for cities and towns to borrow money and greatly increase the rates at which they must renew maturing obligations. Under these circumstances, removal of the tax exemption on municipal bonds would, in my judgment, work more hardship on the home owner and rent payer and would be most ill advised at the present time.

Question No. 2: As to question No. 2, I am in favor of such removal on the condition that the immunities of salaries of Federal employees from State taxation also be removed.

Question Nos. 3, 4, and 5: With regard to reciprocal taxation by legislation, I have not a clear enough idea of the possibilities of reciprocal taxation to be able to express a well-considered opinion. As to bonds, of course, I am of opinion that the thing to do is to wait until a favorable time and repeal all tax immunities, Federal, State, and municipal. I am in favor of doing nothing at the present time. Perhaps, therefore, I am able to say categorically, "No," in answer to Question No. 3.

With regard to question No. 4: If it is possible to remove tax immunities of Federal, State, and municipal employees completely, without a constitutional amendment, I am in favor of it, but I am not in favor of any incomplete legislation as to the practical details of which I am uninformed.

I am unable to answer question 5, as it is not possible for me to be present at any hearing.

(2) Upon receipt today of the ballot on taxation immunities, I immediately advised the city council of the request of the National Institute of Municipal Law Officers that such ballot receive immediate attention, with the result that the city council directed me to mail to you a certified copy of a resolution adopted by the city council on December 19, 1938, which you will find herewith enclosed, and which doubtless will prove self-explanatory.

Although the certified copy of the resolution enclosed herewith does not constitute a vote by me on the ballot which came this morning, you may nevertheless make such use of this resolution as you may deem necessary. (Resolution attached.)

(3) John F. Bonner, Minneapolis, Minn. (assistant city attorney): In the absence of the city attorney, I am answering your inquiry.

I think the inquiry can best be answered by enclosing herewith copy of resolution adopted by the city council on December 9, 1938, copies of which have been sent to the Senators and Representatives from Minnesota and to the Conference on State Defense. (Resolution attached.)

(4) William C. Chanler, New York, N. Y. (telegram). Replying questionnaire taxation immunities record me as opposed to removal of immunities of present and until appropriate compensatory adjustments are made. Should immunities be removed from municipal bonds at once an additional burden would be placed on small taxpayer as stated by John N. Sebrell in questionnaire. However, believe that plan can be worked out which would result in elimination or substantial curtailment of existing immunities.

Mr. KELLY. I may say on behalf of the special committee of the Institute that we are unanimously opposed to the taxation of income from municipal bonds, and, as the statement tendered for the record shows, city attorneys are almost unanimous in their opposition.

I do not want to duplicate any testimony which has already been given, but I do believe it well that I illustrate the practical legal effect of the President's proposal by taking as an example my own city of Detroit.

Taking, for example, my own city of Detroit, the effect on the city of Detroit of the proposal to authorize Federal income tax on interest yield of municipal bonds: Estimates of increased interest cost vary from one-half of 1 percent to 1 percent, with most authorities figuring an 0.6 average increase.

In the course of the general refunding of Detroit bonds, in 1933 and 1934, a sum in excess of $200,000,000 of its bonded debt was converted into callable bonds. Since 1934, approximately $80,000,000 of these bonds have been called for payment out of the proceeds of refunding bonds sold at substantially lower interest rates than the bonds refunded.

This refinancing is saving the city of Detroit the sum of $1,142,000 in interest charges each year. The city will still have the sum of approximately $115,000,000 of callable bonds bearing an interest rate of 4 percent and higher, of which sum $74,000,000 worth bear interest in the amount of 4½ percent or higher. These bonds may be refunded in a similar manner when market conditions and the credit of the city permit. The city could readily save an additional $1,000,000 a year in interest charges by reason of such refunding. If Congress took immediate action to tax future issues without a constitutional amendment, and the same was upheld by the Supreme Court, Detroit would be unable to continue its refunding program as the new issues of refunding bonds, if taxable, could not be sold at a lower rate of interest or at a sufficiently lower rate to create any substantial saving to the city. On the contrary, if the proposal to tax future issues of State and municipal bonds is to be provided by constitutional amendment, the city would have sufficient time to carry out its refunding program and save the taxpayers many millions of dollars in interest charges.

If the legal right, as alleged by the office of the United States Attorney General, to tax the income from municipal bonds exists, the right to tax the revenue of certain municipal departments could readily

be asserted. The effect upon the municipal water department of such a tax upon its revenue has been briefly estimated as follows:

After deducting an estimated depreciation allowable under existing Federal income-tax laws, the water department of the city would have had to pay a tax on a total income from 1921 to 1938-39 of $7,300,000. The taxable income for this 17-year period varied in amount from the sum of $200,000 to $1,600,600 per year, with an annual average of $430,000. The taxable income of this Department for the next 13 years has been estimated to be in the total sum of approximately $8,700,000, varying in amount from $100,000 to $1,600,000 per annum with an annual average of approximately $670,000.

In addition to the added expense of a tax upon the revenue of the system, the cost of an appraisal, and changes in the bookkeeping system that would be required, should be taken into consideration. In order to set up plant accounts in the form demanded by the Federal Government, a complete appraisal of the system would be necessary which, together with the bookkeeping change, would involve an estimated expenditure of $200,000 with an added annual expense of $25,000 to keep the changed system up to date.

Publicly owned utilities are not operated for profit, but to render service at the lowest possible cost. It is apparent that a tax upon the revenue, together with the additional expense of appraisal and changed bookkeeping systems, now unnecessary, would constitute a tremendous and unjustifiable burden upon the water consumer.

I gather the purpose of the proposed legislation here considered is to reach large incomes derived from the present tax-exempt security. While I confess that I am not a financial expert, nor do I thoroughly understand the economics of this proposed legislation, I do know that a great portion, if not all, of the tax which the Government would receive will be passed on through the increased rate of interest to the already overburdened taxpayers of the municipality.

For example, if the law had been in effect and the present bonds of the city of Detroit were charged with this increased rate of interest instead of what they are now paying, instead of the city of Detroit having to raise by taxation and revenues a sum of approximately $15,000,000 to meet the interest on the bonds for the current year, the city would be obliged to raise approximately $3,000,000 more, which would be a direct burden upon the taxpayers, the water users and the car riders of the city of Detroit.

In other words, whatever the Federal Government might get in the way of revenue would be more than offset by the burden which would be loaded on home owners who pay city taxes. Conceived, apparently, as a way to force wealthy investors to put their money elsewhere than in Government bonds, this legislation would boomerang on those least able to afford it. If the object of the proposal is to realize the capital market and pour oil on the national economic machine, as administration officials have said, it appears to me that there are other methods of attack on the national economic problem that would do less harm and more good.

STATEMENT OF HON. HARRY McMULLAN, ATTORNEY GENERAL OF THE STATE OF NORTH CAROLINA

Mr. McMULLAN. Mr. Chairman and gentlemen of the committee, as the chief law officer of the State of North Carolina and on behalf of my State, I respectfully ask permission to state my objections to the Federal proposals to tax the income from the bonds and securities issued by my State and its political subdivisions. In my opinion the Federal Government is wholly without constitutional power to assess such a tax unless and until that power is expressly vested in the Congress by a constitutional amendment.

As one of the signers of the memorandum which the States have placed before this committee I have formally registered my legal objections to the proposals. I propose today to confine myself very briefly to a discussion of the sixteenth amendment.

In my opinion the phrase "from whatever source derived, without apportionment" as used in the sixteenth amendment, cannot be deemed to mean that the Congress has the power to tax the income from State and municipal bonds. The Department of Justice, I know, takes a contrary view, but in my opinion their view cannot be supported except by ignoring the most pertinent facts in the records surrounding the adoption and ratification of that amendment.

In the first place, it will be recalled that the sixteenth amendment was only made necessary by reason of the fact that the Supreme Court in *Pollock* v. *Farmers Loan & Trust Company*, 157 U. S. 429 (1895), had held that a tax upon the income from real estate and personal property was direct and therefore subject to the rule that it must be apportioned among the several States. This rule laid down by the Supreme Court, as we all know, made the taxation of income from real estate and personal property wholly impracticable. The only solution therefore was to amend the Constitution.

On June 16, 1909, the then President of the United States sent a special message to the Congress in which he recommended that the both Houses propose an amendment conferring power upon the National Government to levy an income tax "without apportionment among the States in proportion to population." On the very next day a Senate joint resolution was introduced by Senator Brown and it provided—

> that Congress shall have power to lay and collect direct taxes on income without apportionment among the several States according to population.

Subsequently the Senate Committee on Finance substituted for the word "direct" in the above resolution the phrase "from whatever source derived." The substitution was made without discussion or explanation and accordingly it must be obvious to all constitutional lawyers that it was intended only as a more precise and satisfactory substitute for the word "direct."

Moreover, the phrase "from whatever source derived, without apportionment" was never discussed in the Senate or House except on one occasion when it was observed that the phrase would permit the taxation of individuals as well as corporations.

After the Senate joint resolution had been adopted by the Congress and it was already before the States for ratification, the then Governor of New York showed some apprehension that the amendment might be interpreted to permit a tax upon State and municipal bonds;

However, as I study the record these apprehensions were immediately set to rest by three outstanding Senators who were intimately identified with that amendment. Senator Borah, one of the most ardent proponents of the amendment, came out upon the floor of the Senate and explained at great length that the amendment was not intended to permit such a tax as the Governor from New York feared might result. Senator Brown, who introduced the amendment, also joined Senator Borah and he too said that it was not intended to extend the scope of the Federal Government's taxing power to subjects which were heretofore immune. And I might add parenthetically that the income from State and municipal bonds had been held immune from Federal tax in the *Pollock case*, to which I have referred, by every one of the Justices who sat in the case.

Senator Elihu Root of New York, said by some to have been the actual draftsman of the amendment, notified the New York State Legislature that in his opinion the amendment could not be interpreted so as to permit a Federal tax upon the securities of the State of New York. The answer of Senator Root was immediately publicized by the papers. It was referred to as "an able presentation of his reasons for differing with Governor Hughes' views." Another paper characterized his letter as "unanswerable" and said "Mr. Root proves the amendment does not open a way for the taxation of State securities." In my opinion the States of the Union ratified the amendment only after the apprehension expressed by the then Governor of New York had been thoroughly allayed by Senators Borah, Root, and Brown. In the case of my own State, the message of the Governor indicated that he was not in thorough accord with the views expressed by Governor Hughes. Under these circumstances I fail to see how under any possibility the Department of Justice can have any reasonable hope of sustaining its interpretation of the amendment.

The record fully proves that the resolution was never passed in the Congress, and the amendment was never ratified by the States, under any circumstances which would remotely support the proposition that the States were yielding their immunity from Federal taxes while at the same time the Federal Government was preserving its immunity.

The amendment, Senators Borah, Root, and Brown said at the time, was adopted solely to overcome the unworkable rule that certain direct taxes had to be apportioned among the States.

And now, if the committee will bear with me and permit me to deviate briefly from the law, I should like to point out how seriously the proposed tax will affect the State of North Carolina.

On June 30, 1938, the total State and local debt in North Carolina was $515,900,687. Broken down this debt is divided as follows:

County	$147,700,245
District	22,551,164
City	158,765,478
State	161,931,000
Floating debt, miscellaneous, estimated	25,000,000

The annual bond interest cost of this State and local debt is $27,798,000 per annum.

As the attorney general of the State it is not my province to estimate the increased interest cost which will result to the State if, as and when the income upon its bonds is subject to Federal tax. But I am advised on the basis of studies which have been made, that the interest

rate will increase, conservatively, at least 60 points or ⅗ of 1 percent. This means that North Carolina's State and local interest cost will increase in excess of $3,000 000 per year.

As our indebtedness is only one-third State, one-third city, and one-third county, we would have increased taxes to be collected each year from the people of the State of $1,000,000, for the State, $1,000,000 for the counties, and $1,000,000 from the municipalities.

Many authorities estimate that the increase in cost will exceed 60 points, and will approximate 100 points. Quite obviously, if this is so my estimates of the increased interest costs in the State of North Carolina are too low.

But whatever the amount may be, the increased interest cost for the State must be provided for. Our revenue system is already overburdened with demands and our taxes are now considered as high as they should go. In the face of so much opposition the State has been compelled to include with its income tax a 3 percent sales tax in order to provide for payment of the operating costs of its school term and other expenses of State government. The tax rate in the various cities and municipalities of North Carolina could not be substantially increased without endangering their financial structure.

In conclusion, I should like to point out that the State of North Carolina can hope to gain very little from the right to impose a tax upon Federal bonds. In the first place, the municipalities and counties alone who would suffer as I have indicated, to the tune of about $2,000,000 per year would have no right to levy income taxes and accordingly they could gain nothing. As for the State itself, the amount of Federal securities held in North Carolina is comparatively small. In 1937 all the banks in North Carolina held a total of $87,-000,000 of Federal obligations. Only a small amount of Federal securities are held by individual taxpayers.

It is self-evident that North Carolina, and other States like it, have much to lose and nothing to gain by the proposal submitted to Congress. These considerations of loss and gain far outweigh the efforts made to reach untaxed sources of income.

No proposal is made that the Federal Government shall pay back to the States and political subdivisions as compensation for losses the additional revenue produced for the Federal Government. In the event that such legislation should be enacted by proper constitutional process, it would seem at least fair that the money collected by the Federal income tax should be restored to the State and local governments to offset, as far as it will go, their increased cost of borrowing. The net result of all of this would be to pyramid taxation, without practical benefit to either the Federal or State Governments. The doctrine of immunity of taxation in our system of government has been the national policy for more than 100 years. The foundation of the doctrine was considered to be the essential relationship between the Federal and State Governments. It cannot be abrogated without raising many other problems of intergovernment taxation.

Should we depart from the time-honored principle supported by the unanimous line of authorities of the Supreme Court of the United States, many questions will arise as to other forms of Federal and State taxation.

If immunity is broken down—to illustrate, the Federal Government might, upon the same principle, tax the incomes of municipally operated power plants; the States might tax Federally owned lands which are not used as essential activities of the Federal Government. Vast and complex problems of Federal-State taxation will necessarily arise once the principle upon which immunity is founded is put aside.

Finally, I want to say that the sovereign State of North Carolina protests strongly against the Federal Government's attempted invasion of the 106-year-old doctrine of States' immunity from tax. Because that invasion is bound to seriously disrupt the fiscal affairs of the State, we in North Carolina believe that the matter should at least be referred to the States for their consent by proper constitutional process. We ask the committee, therefore, to confine such affirmative action as it chooses to take solely to the method of constitutional amendment.

The CHAIRMAN. Thank you, Mr. McMullan.

We will now recess until 2 o'clock.

(Thereupon, at 12:40 p. m., a recess was taken until 2 p. m., of the same day.)

AFTERNOON SESSION

(The committee met, pursuant to recess, at 2 p. m.)

The CHAIRMAN. The committee will come to order. We will now hear from Attorney General Walsh, of Maryland, for 10 minutes.

STATEMENT OF HON. WILLIAM C. WALSH, ATTORNEY GENERAL OF THE STATE OF MARYLAND

Mr. WALSH. Mr. Chairman and gentlemen of the committee:

I am appearing before you as the representative of the State of Maryland, to object to the proposal that the Federal Government impose taxes on the bonds or other obligations of a State or any of its political subdivisions, or on the income from such obligations. I am not going into any details as to the law. My observations are going to be general on the grounds that this is a further interference of State rights.

The power to tax is an attribute of sovereignty, and it can only be exercised over those who are subject to the sovereignty which imposes it. It follows that the imposition of a Federal tax on State and municipal obligations, or the income from them, would mean that the sovereignty of the national Government is superior to that of the States, and as I see it, this would be contrary to the system of government established by the Constitution.

Under the Constitution, the Federal Government was to be supreme in national affairs and the sovereignty of the States was to be recognized in local affairs. The Constitution contemplated two separate sovereignties, between which sovereignties all the powers of government were divided, those of a national character being conferred upon the Federal Government, while all other proper governmental powers were reserved to the States, and at the same time certain rights, over which neither sovereignty had power, were reserved to the people. But the Constitution did not contemplate that the national sovereignty should be superior to the State sovereignty, nor that the State sovereignty should be superior to the national sovereignty. Each

sovereignty was to be supreme over the matters allocated to it, and up to the present time our problem has been to determine whether a certain power belonged to the National Government, or belonged to the State government, and in my opinion, the genius of the American people and of our institutions has been able to solve this problem with a minimum of mistakes.

Now, however, we are confronted with the assertion that the Federal Government possesses the power to tax the obligations of the States or their subdivisions, and in my judgment such action would constitute a serious infringement on the sovereignty of the States.

The Supreme Court has repeatedly stated that the Federal Government does not have the power to tax the obligation of the States and, as is conclusively shown in the brief of the attorneys general filed with this committee, the sixteenth amendment to the Constitution did not confer any such power on the National Government. It, therefore, follows that, if the present proposal is enacted into law, the Supreme Court will have to declare it unconstitutional, or retract what it has been saying for the past 100 years or more, and it does not seem to me that the Congress of the United States should pass a law which the Supreme Court has clearly indicated is not constitutional.

The great majority of the people of Maryland firmly believe in the maintenance of the rights given the Federal Government by the Constitution, and they believe equally in the maintenance of the rights reserved to the States by that same Constitution, and, in my opinion, they do not believe in seeking and searching for new ways by which more and more power can be given to the National Government at the expense of the State. If this additional power of taxation is to be given the Federal Government it should, I think, be secured by a constitutional amendment. If such an amendment were adopted there would be no further question of the existence of the power, but I do not believe it is sound to attempt to exercise the power by a statute, where so much doubt exists as to the constitutionality of such a statute. Furthermore, if such an amendment is proposed it should give the States the right to tax Federal securities, as well as give the Federal Government the right to tax State securities.

In addition to the legal objections to the proposal, I am unable to see any economic advantage in it.

It is admitted on all sides, that one result of the taxing of State and municipal securities by the Federal Government will be to increase the cost of State and municipal government. The tax will result in decreasing the price which can be secured for the securities, or will require the payment of a higher interest rate, and so State and local communities will be required to pay more money for the State and local improvements which are built with the proceeds of such securities. This, of course, means that the taxes on the individual taxpayers in each State, county, and municipality, will be increased, or the amount of improvements which they could previously obtain for a given amount of taxes will be increased.

One of the purposes of the present proposal is to prevent the accumulation of large amounts of tax-exempt securities by wealthy people, with the consequent avoidance of taxation by such people.

I do not favor the avoidance of taxation by the rich, but it seems to be conceded that a comparatively small percentage of outstanding

State tax-exempt securities are held by people of great wealth, so that the situation is not as serious as many have been led to believe. There is such a thing as the cure being worse than the disease, and personally, I would prefer that a few wealthy escape taxation rather than have a further encroachment made on State sovereignty in an effort to tax them.

Ever since the Constitution was adopted, there has been a contest between the National Government and the States on the question of the respective powers of each, and in this contest, the National Government has usually been the winner. Without stopping to consider the wisdom of the results up to this time, I think all will concede that the powers of the Federal Government would be far greater than they now are, had not the States, throughout the course of our history made a determined effort to prevent the enlargement of the powers of the National Government. And believing, as I do, that the real welfare and happiness of the American people are best served when their local affairs are controlled by their local State government, and that the chief danger to the liberties of the people is to be found in too much centralization of power in the National Government, I am in favor of continuously striving against the acquisition of any new power by the National Government, unless that power is clearly needed and is given to it by constitutional amendment.

The CHAIRMAN. Thank you, Mr. Walsh.

STATEMENT OF HON. GRAY MASHBURN, ATTORNEY GENERAL OF THE STATE OF NEVADA

Mr. MASHBURN. Mr. Chairman and gentlemen of the committee, if the committee please, I appear in my official capacity as the attorney general of Nevada to present the protest of my State against the proposed taxation of State and municipal bonds.

Our opposition is based on two counts: First, we believe the proposed tax is beyond the power of Congress to levy by statute; second, we believe it to be economically unsound and detrimental not only to the States, and to the State of Nevada in particular, but also to the Federal Government and the Nation as a whole.

The legal brief which has been submitted to this committee on behalf of the attorneys general of the States demonstrates clearly, I believe, that a constitutional amendment will be necessary to invest Congress with the power that the Treasury now claims for the Central Government. No decision of the Supreme Court has even suggested that the Federal taxing power extends to the fiscal operations of the States and their subdivisions. Nor can any distortion of the sixteenth amendment be successfully upheld so as to grant Congress such power.

The contention of the Department of Justice that the Federal Government is the supreme taxing power in this Nation expresses a shocking concept of American government. The great body of constitutional law which exists in this country was founded upon the premise that each government must remain free from interference by the other. We concede that in its expressly delegated fields the Federal Government is indeed supreme, but we insist that in the exercise of their reserved powers, the States also are supreme and cannot be impeded or burdened by the Federal Government.

The right to be supreme in the management of its own fiscal affairs is one of the prime attributes of the sovereignty of any government. If the Congress has the right to interfere with and disrupt the fiscal operations of the States, then the sovereignty which was guaranteed to them by the Constitution no longer exists. It is our determined contention that such an interpretation of our Constitution is completely unsound.

The State of Nevada has made, and is making every effort to carry on its government at a minimum of expense. Nevada is in the peculiar position of being able to tax only 13 percent of the acreage located within its territorial boundaries, since 87 percent of the State consists of federally owned land. Nevertheless, Nevada has been able to operate its government without the imposition of nuisance taxes and income tax, and many other taxes which are accepted as a matter of course in most States today. To tell us that we may in return tax Federal securities is simply laughable. We have no income tax, and moreover, the holdings of Federal securities in Nevada are negligible. If there was any real intention of eliminating immunities and doing so on a reciprocal basis, we should like to sit down with the Department of Interior and discuss the taxation of that 87 percent of our lands held by the Federal Government.

There are now outstanding bonds of the State of Nevada in the sum of $860,000. These bonds are entirely held by various public funds of the State of Nevada. These agencies moreover hold other State and municipal bonds to a total value, including those of the State of Nevada, of $3,146,657.

The imposition of the proposed tax, even though limited to future bonds would necessarily establish the constitutional power of Congress to levy a tax upon bonds already outstanding and would unquestionably result in depressing the market value of State and municipal securities. In addition, the bonds of the State of Nevada were sold to these funds on the representation that they were free from taxation. The money to pay the taxes on them might therefore well have to be paid directly by the State. This would have a direct effect upon the State since the loss will be borne directly by the State and its agencies.

Moreover, the legislature of our State is now carefully investigating a comprehensive refunding program. Should a tax be levied upon future issues of State bonds, it would, of course, be necessary to increase the rate of interest which these bonds would bear. Any refunding would be seriously affected by this increased cost and a complete disruption of the whole program would undoubtedly result.

In this connection, I desire to read into the record a telegram received by me from my Governor, Hon. E. P. Carville. It reads as follows:

Hon. GRAY MASHBURN,
Attorney General of Nevada, Washington, D. C.

Desire you as representative of Nevada to inform Senate committee of the determined opposition of our State to the imposition of a tax on State and municipal bonds by congressional statute. Agree unqualifiedly with your conclusions that such a tax is unconstitutional. Moreover, tax would be a severe hardship upon our State and its municipalities. Increased interest costs will substantially raise the cost of government. Entire refunding program now being studied by our legislature will be seriously jeopardized. Authorize and instruct you to resist this proposed tax both on constitutional and economic grounds.

E. P. CARVILLE,
Governor of Nevada.

The CHAIRMAN. Thank you, Mr. Mushburn.

STATEMENT OF HON. ABRAM P. STAPLES, ATTORNEY GENERAL OF THE STATE OF VIRGINIA

Mr. STAPLES. Mr. Chairman and gentlemen of the committee, I am very grateful for this privilege of appearing before this committee in my official capacity as attorney general of Virginia and for this opportunity to press upon your consideration the interests of my State, as I conceive them, with respect to the proposed legislation now pending before you, for I have received many requests from chambers of commerce and other organizations in Virginia to make a protest against same.

The effect of the proposal, as I understand it, is to impose a Federal tax upon incomes derived from State and municipal securities—that is, to remove from such securities the characteristic, now inherent in them, of immunity from the burden of Federal taxation. I am told that there are two outstanding purposes which are sought to be accomplished: first, an increase of the Federal revenue; and, second, the removal thereby from the very wealthy of this source of refuge and escape from the payment of income taxes. So far as the first purpose is concerned—the increase of the Federal revenues—I do not believe it logical to achieve this at the expense of increasing the burden on State and municipal treasuries.

For some years the Congress has found it necessary to supplement local revenues with grants from the Federal Treasury running into the billions of dollars in order for the States to take care of their social security obligations and provide for the needy and unemployed. I believe, therefore, from such study as I have been able to make of the subject, that any increase in Federal revenues from this source would be more than offset by the enlarged needs for grants from the national Treasury made necessary by the increase in cost of the State and municipal debt service and the resultant depletion of the local treasuries.

But even if this be not true, and even if there would be a net increase in the balance finally remaining in the Government Treasury, this proposed method of enhancing the Federal revenues at the expense of the States, and through an indirect tax levied upon them without their consent, is wholly repugnant to our conception of the fundamental principles inherent in the very structure of the State and Federal Governments.

While there is no present prospect that the Commonwealth of Virginia will issue any bonds in the near future, or in the distant future either, for that matter, her municipalities are constantly growing and compelled, or their governing authorities think they are compelled, to issue bonds for improvements to conform to municipal expansion. Furthermore, many county and municipal issues how outstanding will have to be refunded, in whole or in part, within a few years. The increase in interest rates at which taxable bonds for new improvements or taxable refundings must be sold will present a most serious problem and in many cases impose a tremendous burden and hardship upon our municipal and county governments.

Turning next to the second main purpose of the proposed legislation, I believe the people of Virginia are in enthusiastic accord with

the thought that it is highly desirable to prevent tax-exempt bonds from being used by a taxpayer to avoid payment of such proper income tax as the Congress may see fit to impose upon him. There can be no doubt that very wealthy persons do escape surtaxes by this means, and that it is an evil which should be corrected. But, great though the evil be, it is not nearly so great as that which would result from this proposed thrust at the dignity and sovereignty of the States. That Virginia and the other original States, when they created the Constitution and the Federal Government, reserved this sovereignty unto themselves, no one at all familiar with history will deny. But I understand the Bureau of Internal Revenue to contend before this committee that there has taken place some sort of "metamorphosis in the relations between the Federal Government and the States" and that the State sovereignty, which our forefathers were so careful to preserve as the foundation upon which to erect the National Government, has thereby become eclipsed and obliterated. It is true that conditions brought about by the depression have necessitated a very material expansion in the activities of the Federal Government, but we of the State governments have been given to understand that such activities were, for the most part, due to the emergency, were only temporary and would be followed, when times permitted, by a return to normalcy. We have therefore dared to hope that such partial eclipse of State sovereignty as may have occurred would be followed, as all eclipses are followed, by a return of the bright sunshine.

No one agrees more sincerely than I do with the doctrine that the Constitution is not static but is and should be a live and breathing instrument; that conceptions of powers thereby conferred on the Congress or reserved unto the States should properly change as conditions change, and that the courts should take cognizance of these changes. But to invoke this doctrine as a conclusion that State sovereignty, the very foundation on which our Nation was erected and has grown great, may be ripped out from under it and cast into the junk pile is an argument so utterly foreign to any I have ever heard before, that I must confess to being completely astounded at its advancement, and especially in such an exalted atmosphere as this committee of the august Senate of the United States. The supremacy of the Federal Government, in its own proper sphere and field, as delineated in the Constitution, we most cheerfully concede, but just as earnestly do we insist upon the supremacy of the government of our State in its proper field as established by that instrument.

The constitutional immunity of the State governments from Federal taxation is established by the decisions of the Supreme Court equally as firmly as is that of the United States from State taxation. The decisions likewise leave no doubt that such immunity is a necessary attribute of sovereignty, and that a tax by either upon the income from the bonds of the other is an infringement upon that sovereignty. That this is the effect of the Supreme Court's decisions I do not understand to be controverted. The Bureau of Internal Revenue, however, affects to find in the recent *Gerhardt case* a reversal of this doctrine. But the opinion in that case was a discussion, not of the question of whether State immunity in fact existed, but solely of the question as to the nature of the governmental agencies or instrumentalities to which such immunity extended. The most far-reaching effect which can possibly be given to the opinion is that a broader and more liberal

rule of classification to determine immunity should be applied to Federal Governmental agencies than to those of the States. That is, a Federal agency, exercising given functions, might be held immune from State taxation, while a State agency, exercising identical functions, might not be classified as enjoying immunity from Federal taxation. I do not concede that the case goes so far as to hold this. But I do say that it cannot reasonably be argued that it goes further.

It is said also that Congress should help to persuade the Supreme Court to reverse these decisions sustaining State sovereignty which were rendered before the so-called metamorphosis and eclipse took place. This request is entirely foreign to my conception of the function of the Congress. On the contrary, I have always thought the Department of Justice was entrusted with the duty of persuading the courts, and I am wondering whether the congressional action asked for is sought for its persuasive or for its supposed coercive effect upon the Court. There are evidently some who entertain the belief that the so-called metamorphosis has destroyed, not only the sovereignty of the States, but the separate independence of the executive, legislative, and judicial branches of the National Government as well.

It cannot be said that this congressional action is necessary in order for the Supreme Court to have an opportunity to overrule its former decisions, because many cases come before it every year involving the application of the immunity doctrine. Under these circumstances, I confess I am at a loss to understand what the modern theory is on which Congress is requested to enact a statute directly in violation of, and in the very teeth of principles as firmly established by the decisions of our Supreme Court, as these principles are. Whether such action is calculated to build up or to destroy public confidence and respect for that much revered tribunal is a very delicate question and is one, not for me, but for this committee and the Congress itself to decide.

Let me state, in conclusion, that I do not wish to be understood as opposing the submission to the States of a constitutional amendment permitting reciprocal taxation by the State and Federal Governments of the income from each other's securities. It may be that the proposed amendment would remove the immunity as to surtaxes only, or it might provide for the respective governments to transmit, each to the other, any tax so collected. These are questions for Congress in its wisdom to decide. But I do wish to urge on behalf of Virginia, with all the earnestness I possess, that under our Constitution, and the methods therein provided for its amendment, the States should be permitted to decide whether there has been, or should be, such a metamorphosis in the fundamental principles of our Government as that the hallowed traditions, sovereignty, and independence of Virginia, within her allotted sphere shall perish from the earth.

The CHAIRMAN. Thank you, Mr. Staples.

STATEMENT OF HON. GREEK L. RICE, ATTORNEY GENERAL OF THE STATE OF MISSISSIPPI

Mr. RICE. Mr. Chairman and gentlemen of the committee, if the committee please, I represent the sovereign State of Mississippi, and with your permission I should like to register my protest against the recent proposals of the Federal Government to tax State and municipal securities by a simple act of Congress. The detailed

reasons upon which I base my objections to the proposal have been fully and formally stated in the memorandum which I signed in my official capacity as the attorney general of the State of Mississippi along with the attorneys general of the other States.

The committee has already had placed before it by the honorable solicitor general of the State of New York the reasons why the conclusions advanced by the Department of Justice in its study are unsound—and accordingly why their assertion that Congress can tax State and municipal securities by a simple act of Congress is ill founded. I shall content myself very briefly with pointing out to this committee some of the absurd results which must inevitably follow from the contentions advanced on behalf of the proposals.

Thus it is said that the sixteenth amendment must be read as vesting Congress with the power to tax income from any source. If this is true, I fail to see any logical reason why the rule would not be extended so as to permit the Federal Government to tax the States and their municipalities. Since the States have income and since the language of the amendment is not confined to personal income alone, what is there to prevent the Federal Government from taxing the States or their cities on an income which they derive from municipal power plants, from street-railway systems, from ferries and bridges, and dozens of other governmental activities which produce revenues, and even upon the revenues derived from the collection of State and local taxes? This may sound like an absurd and preposterous proposition, yet the Federal Government has never answered the charge that their interpretation of the amendment leads inevitably to the taxation of State and city revenues. In my opinion it is no answer to say that the Members of Congress as representatives of the States, would not permit such taxation. I am concerned not with what this Congress will do or will not do in that respect; I am concerned with the danger that some future administration might seize the current interpretation of the amendment as a means of taxing State and municipal revenues.

I do not wish to labor this point, yet I think it is serious and warrants a big discussion. Let us confine ourselves for a moment to a single phase of governmental activity; the operation of municipal water, power, and light plants. In the State of Arkansas, for example, the city of Jonesboro, with a population of 12,000 people, operating a municipal power and light plant, had a net income for 1936 of approximately $80,000 from its power and light plant alone. If this income were taxed at an assumed rate of 13¾ percent (the rate which prevailed under the revenue act of 1932) that city would pay the Federal Government a tax on its light and power plant of $11,466.54. That, I take it, is not a large amount when compared with the figures to which the Congress of the United States is accustomed. I do believe, however, that the citizens of Jonesboro would regard it as a substantial amount of money. For instance, in my own State of Mississippi the city of Greenwood, also having a population of 12,000 derived a net income in 1936 of approximately $143,000 from the operation of a municipal light and power plant. Based on the same assumed rate of tax, the citizens of that city would have to pay the Federal Government approximately $19,000 in taxes. I know definitely that in my State that would be considered indeed a large sum of money.

In Kentucky the city of Henderson, again a city of some 12,000 people, derived approximately $91,000 net income in 1936 from the operation of its municipal light and power plant. Here too the Federal tax would be in the neighborhood of $12,000. In the city of Holland, Mich., a city of some 17,000 people, the municipal light and power plant returned net income for 1936 of $187,000. Here the citizens would be compelled to contribute some $25,000 in estimated taxes. Thus, you can see why it is that the mayor of the city of New York, when he appeared here before this committee the other day, said that the proposal to tax State and municipal securities was one which was agitated by those who were opposed to muncipal ownership of public-service functions.

The obviously impossible results which flow from the position of the Department of Justice are not restricted to their arguments with regard to the meaning of the sixteenth amendment. Similar flaws run through their entire argument on the immunity rule. They say that there are many fields in which the Federal Government can tax State agents like the Government contractor and the Government lessee. Of course, these so-called analogies are just as inconsistent with the exemption of State and municipal revenues as they are with the exemption of their bonds. And if the argument that the power to tax involves the power to destroy is only "a relic of an older jurisprudence" as the Department of Justice insists, I suppose we can't complain if the Federal Government asks the State of Mississippi to file income tax returns. Certainly they have argued that there is no objection to the taxation of our bonds that would add to the cost of our government. And so I suppose they are ready to say that we can't complain that a tax on our revenues would add to the cost of our government.

But there is an inevitable consequence from all the arguments which the Department of Justice has made which flatly contradicts their own position. Every argument which the Department of Justice gives against State and municipal-bond immunity would make Federal bonds just as taxable by the States under the Constitution. Nevertheless, the Department of Justice insists that the rule is not reciprocal and that the States still may not tax Federal securities without Federal consent. It is given as an inconsistent analogy to State-bond immunity that a Government contractor is taxable. But the case which they happen to point to was that of a Federal contractor, not a State contractor. And so, if there is any inconsistency, Federal-bond immunity seems more directly affected by that case than State-bond immunity. They say that Marshall's dictum, that the power to tax involves the power to destroy, is no longer a valid objection to taxation of State and municipal bonds. But that statement was made by Marshall in a case which concerned Federal immunity. In other words, if it is no objection that the power to tax involves the power to destroy, *McCulloch* v. *Maryland* and every case on Federal immunity which followed it, was incorrectly decided.

In other words, the Department of Justice argument proves too much. They have insisted that the Federal Government is constitutionally immune from State taxation. But their arguments, if they were valid, would prove just the opposite. Unlike the inconsistent position of the Department of Justice, I submit that the position of the States is consistent throughout. We say that neither

the States nor the Federal Government may tax each other if the tax will impose a direct burden on governmental functions.

By respecting the law as it stands, the States submit that their position avoids the absurdities into which the Department of Justice has fallen. We are not compelled to take the position that immunity is a Federal monopoly while proving the contrary, nor are we compelled by our arguments to claim the right to tax Federal revenues.

I submit, on behalf of the State of Mississippi, that any legislation to tax the securities of the States and municipalities cannot be upheld.

The CHAIRMAN. Thank you, Mr. Rice.

STATEMENT OF HON. RALPH O. BREWSTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MAINE, APPEARING ON BEHALF OF HON. FRANZ U. BURKETT, ATTORNEY GENERAL OF THE STATE OF MAINE

Mr. BREWSTER. Mr. Chairman and gentlemen of the committee, Attorney General Burkett, of Maine, had been most anxious to appear before your committee on behalf of the State of Maine and to join with his brothers, the attorneys general who have appeared here today, in formal protest to this committee against the constitutionality of the proposal under consideration. However, the legislative session in Augusta has made it impossible for him to get away, and he has therefore asked me to appear on his behalf today as the spokesman for the State of Maine.

The Department of Justice has submitted to this committee a study in which we find the startling assertion (p. 10), attributed apocryphally to Marshall--

> that the principle of immunity protected the Federal Government against taxation by the States, but did not reciprocally shield the States against the exercise of the delegated, and supreme, taxing power of the Central Government.

In other words, we are told that so far as the Constitution is concerned, the States themselves are subject to what is labeled by the Department of Justice itself as the supreme taxing power of the Central Government. The Department of Justice did not say that the Federal Government might tax only State bonds. The language I have read claims that the principle of immunity does not shield "the States" from Federal taxation.

Furthermore, it is my understanding that in his presentation before this committee, the chief counsel for the Bureau of Internal Revenue referred to right of the Central Government to tax the instrumentalities of the States. In other words, Mr. Chairman, we are told now, for the first time in our history, that nothing in the Constitution stops the Federal Government from asking the State of Maine to pay a tax on its own security holdings, or even to file a Federal income-tax return on its revenue receipts. Indeed, the logic of their contention compels them to stand by such an assertion of power, for their whole argument in support of a literal interpretation of the words "from whatever source derived" crumbles to pieces if they are forced to admit that in the course of interpretation that phrase must not, in any way, be qualified.

In Maine, we perform many public services for which we make charges. We have toll bridges, municipal utilities, and similar public works. The committee will, therefore, see why we must view

with genuine alarm an assertion of the chief legal officer of the United States, that the State is absolutely subject to Federal taxation of any kind, with the sole qualification that the tax be not discriminatory as between the State and a private person.

We must also take sharp exception to the contention of the Department that the rule of intergovernmental immunity under our Constitution only works one way; that is, that the Federal Government enjoys the full benefit of this necessary rule of constitutional interpretation but that, on the other hand, it does not shield the States against a direct application of the Federal power to tax. They flatly assert (p. 9) that the rule of immunity is one of "Federal supremacy." They say, of the many cases upholding the equal immunity of the States from the Federal power to tax, that they cannot "confidently be said to be good law today." And finally, they make the perfectly amazing statement that, though the *Pollock case* is the law of the land today, "this is not a matter of great importance" (p. 61).

It is our position that these sweeping assertions are in complete error. For the past three-quarters of a century the United States Supreme Court has never once deviated from the view that the immunity rule gives the States exactly the same protection as it gives the Federal Government. The Department of Justice has tried to build an argument by patching together a scrap of an argument from one case, a dictum from another, a dissenting opinion from a third, and so on. Their arguments had to be indirect, because every direct expression by the United States Supreme Court, whether in majority or minority opinions, would disprove the Department's case. We don't have to rely on indirect proof to show the equal application of the immunity rule to the States. Even restricting our study to the cases cited by the Department of Justice we have been able to list no less than 34 clear recognitions by the Court of the reciprocal character of this rule, as between State and Federal Governments. A quotation of the language which the Court used in each of those cases would no doubt be convincing. But the uniformity with which the Court has upheld the reciprocity of the rule would make such a recital unnecessarily repetitious.

Typical of the Court's repeated statements of the reciprocal nature of the rule is the following language used by Mr. Justice Stone in 1936, when he said that the immunity rule "is equally a restriction on taxation by either of the instrumentalities of the other" (*United States* v. *California*.) Indeed, in many cases the immunity of the States and the reciprocity of the rule were about the only points on which both majority and minority Justices were able to agree.

Many of these statements by the Court may be dicta. As a matter of fact, the Department of Justice says that in—

> only eight cases has a Federal tax ever been declared invalid by the Court as invading an immunity pertaining to the States.

The Department apparently feels that a doctrine isn't well supported if it has only eight United States Supreme Court holdings to back it up. But few doctrines of constitutional law can boast one-half as many supporting precedents. I suppose that the Wagner Labor Act, for example, isn't any the less constitutional because it was upheld in only one United States Supreme Court decision.

We may ask, then, on what does the Department of Justice rely when it urges that the States have no immunity whatsoever? Very simply, it is this—that the Federal Government is supreme, and only this so-called Federal supremacy justifies immunity. It is my considered judgment that such a contention constitutes a very dangerous attack on the States.

The States find a consistent philosophy in all these cases on the immunity rule; that is, that governmental immunity has always been insisted upon by the Court to prevent the disruption of the delicate balance of powers between the States and the Federal Government. In other words, the rule is not based on the supremacy of either government. It is designed rather to avoid a one-sided supremacy which might unbalance the Federal system. That reason obviously applies equally to the Federal Government and to the States. When any of the early cases based the immunity of the Federal Government on "Federal supremacy" it is clear that they meant the supremacy of the "Federal system" and not of the Central Government. The preservation of the States is just as important to the preservation of the Federal system as is the National Government.

All the cases make it clear that there is no such thing as the supremacy of the Federal Government—except, of course, in the fields which the States have delegated to it. And the cases are just as unanimous in insisting that the States are equally supreme in their field. In other words, if supremacy is the reason for the immunity rule, there is no difference between the Federal Government and the States whatsoever. The States are as supreme in their field as the Federal Government is in its field.

The Department of Justice tries to bolster up its argument by certain language in the recent case of *Helvering* v. *Gerhardt*. But there is no intention whatsoever in that case to give the impression that the States have lost their immunity from Federal taxation. In the first place, Justice Stone clearly stated that State immunity was an established and sound doctrine of our constitutional law. As a matter of fact, he said that it had been decided—

> That the taxing power of the Federal Government is nevertheless subject to an implied restriction when applied to State instrumentalities * * *.

And the Court also showed its concurrence in our interpretation of the reason for that immunity. Justice Stone said:

> The immunity which it implied was sustained only because it was one deemed necessary to protect the States from destruction by the Federal taxation of those governmental functions which they were exercising when the Constitution was adopted and which were essential to their continued existence.

In the second place, the Court laid down two careful tests for applying State immunity. Can we possibly assume that they would lay down tests for applying the immunity if they meant to reject the doctrine outright?

But the Department of Justice insists that there is a difference between the Federal Government and the States sufficient to make a difference in their immunity. Thus it is argued, that because the States are represented in Congress they may not complain that a tax levied against them by that Congress is unconstitutional.

In reply, we express some amazement that the Department should champion a suggestion, even though it may have slipped from the pen of a distinguished jurist, that in effect would nullify the entire

reasoning of the doctrine of *Marbury* v. *Madison*. Constitutional rights find their ultimate protection in the Supreme Court and are not to be compromised even by the will of Congress. To suggest that a challenge to the constitutionality of a statute can be met with the obvious irrelevancy that the person or the State who challenges the act has no standing because he was represented in Congress would seem to be a complete distortion, both of the powers of Congress and of the duties of the Supreme Court. Since when has it been a valid argument that the Constitution of these United States doesn't protect an American citizen or a State of the Union because he or it is represented in the Congress? Since when is the Congress free to disregard the constitutional safeguards of the civil and religious rights of minorities because those minorities are represented in Congress?

The Department of Justice's argument seems to say to the States—"What right have you to complain about this act? Your own representatives in Congress passed it."

But there are always minorities in Congress. They may represent agricultural States, seacoast States, Lake States, cotton States, automobile-manufacturing States, oil States, and sometimes, I may add, there are even Democratic or Republican minorities. Suppose the majority of Congress in any such field should take action which prejudices that particular minority in violation of the Constitution. Can the fact that those minority States are represented in Congress possibly be a sufficient answer to them when they seek to prove that the Constitution forbids the action? In the last analysis, such a contention would simply substitute the will of a majority of Congress for the interpretative protection of the Supreme Court.

Suppose some Congress decides to levy a discriminatory tax on State bonds at a rate twice as high as that on any other bonds. It would be cold comfort to the States if their own representatives had passed it. It must be plain, Mr. Chairman, that the contention misses the whole point of a written Constitution.

And if it is a question of the need for the immunity rule, may I suggest that the States need immunity from Federal interference much more than the Federal Government needs immunity from State interference. If I may say so, the Federal Government seems strong enough to protect itself these days. On the other hand, the States which happen to be in a minority at any given time have a much more real need for protection against interference by the Federal Government.

The Department of Justice argues, in effect, that *Helvering* v. *Gerhardt* has abandoned the constitutional guaranty of equal sovereignty as between State and Federal Governments in their respective fields. Four Judges joined in the majority opinion in that case. The record of each one of them makes it impossible to assume that they meant to take any such drastic step. The brief which the States have submitted in opposition to the Department of Justice's study shows convincingly that every one of the Judges who took part in the Gerhardt decision had joined in numerous cases, in which he clearly reiterated the doctrine of equal State immunity. Mr. Justice Stone, who wrote the Gerhardt opinion, also wrote the language I quoted above that the immunity rule—

is equally a restriction on taxation by either of the instrumentalities of the other.

The opinions of Mr. Justice Stone, affirming the immunity of the States, number at least 20. Chief Justice Hughes has supported State immunity in no less than 18 opinions. Mr. Justice Brandeis has to his credit at least 22 reaffirmations of State immunity. The same story applies to each of the other Justices. Each of them has repeatedly emphasized the very rule of equal State and Federal immunity which the Department of Justice disputes.

I submit, on behalf of the State of Maine that this attack on our immunity from Federal interference is of grave concern. We ask this committee to repudiate any suggestion that the States which you represent are not the constitutional equals of the Federal Government in the field of intergovernmental taxation. We urge that if any step to tax the States be considered at all, it should be considered only with the States' consent, by constitutional amendment. Taxation without consent is a protest that goes pretty far back into the origins of American history.

STATEMENT OF HON. MAC Q. WILLIAMSON, ATTORNEY GENERAL OF THE STATE OF OKLAHOMA

Mr. WILLIAMSON. Mr. Chairman and gentlemen of the committee: If the committee please, I am here in my official capacity, as attorney general of the sovereign State of Oklahoma, and with the committee's permission I should like to controvert briefly the facts recently advanced by the Department of Justice in support of the contention that the Congress now has the power to tax the income from State and municipal bonds under the sixteenth amendment.

Our objection to these facts has been formally made in the memorandum on behalf of the States, which I signed as attorney general of the State of Oklahoma. As a result of the study there made we are of the opinion that the sixteenth amendment was never intended, and it does not, vest Congress with any power to tax State and municipal securities. We think our conclusion is supported primarily by the records surrounding the adoption of the amendment and secondly by the judicial precedents of the Supreme Court of the United States.

Before I touch very briefly upon my legal argument, I should like to register, on behalf of the State of Oklahoma, my protest regarding the proposals, from the economic and fiscal aspects. If a Federal tax upon the income of State and municipal bonds will result in an increased cost to the issuing body of from 60 points to 1 percent, as has been estimated, it will mean an increased interest cost to the State of Oklahoma and its cities, counties, and local subdivisions of over $2,000,000 annually, assuming, of course, that after the passage of an act to tax the income upon such bonds, there are issued and outstanding the same amount of State and municipal securities as were outstanding during the year 1937.

Moreover, in my State the privilege to tax Federal securities is more or less of an empty gesture. Hubert L. Bowen, the State treasurer of my State, has advised that "If the income from Federal and State securities were taxed by both the Federal and State Governments, the Federal Government would receive at least four times as much on State securities as the State (of Oklahoma) would receive from a tax

on Federal securities." I understand this is due to the fact that the amount of Federal securities held within our State is relatively small.

With this statement I shall conclude my brief reference to the economic burden which the enactment of such a tax would impose upon the people of my State.

I turn now to the circumstances under which the sixteenth amendment was adopted.

The sixteenth amendment, as we so well know, provides that "The Congress shall have power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several States and without regard to any census or enumeration." The Department of Justice builds its case upon the assumption that the words "from whatever source derived" is to be stripped from its context in the amendment and read "literally," as they put it. So read the Department argues that it gives the Congress power to tax any or all income, irrespective of its source.

However, we have demonstrated in the States' memorandum that the phrase was intended merely as a substitute for the word "direct." Thus we know that in the *Pollock case* the Supreme Court of the United States had decided in 1895 that an income tax upon the income derived from real estate and upon the income derived from personal property was a direct tax. As such the tax could only be levied if it was apportioned among the States of the Union.

I need not point out how impracticable that requirement was. It is dealt with at page 255 of the States' legal memorandum.

We have shown that in 1909 President Taft called upon Congress to "propose an amendment to the Constitution conferring the power to levy an income tax upon the National Government without apportionment among the States in proportion to population."

That was on June 16, 1909. On June 17, Senator Brown introduced Senate Joint Resolution 39, which provided:

> The Congress shall have power to lay and collect direct taxes on income without apportionment among the several States according to population.

On June 28, a few days after Senator Brown introduced that amendment however, the Senate Committee on Finance brought in Senate Joint Resolution 40, which provided:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States and without regard to any census or enumeration.

Now the committee will observe that the difference between Senator Brown's resolution, which he introduced immediately following President Taft's message, and the one reported out by the Senate Committee on Finance, is very simple: The word "direct" was deleted from the first of these two resolutions and the phrase "from whatever source derived" substituted in lieu thereof.

Now, one might well ask why the substitution? The answer, as I see it, is this: The Supreme Court had previously encountered difficulties in interpreting the nature of direct and indirect taxes. It must have been felt, therefore, that the troublesome word "direct" could be obviated and might well be and by the simple expedient of deleting it from the amendment. The record is clear that the substitution was made by the Senate Finance Committee without any explanation on the floor of the Senate and it must, therefore, be obvious that the

change was intended as a simple substitution rather than as a basic change in the structure of the amendment itself. There was no discussion at all.

Now, let us check this explanation with the record of subsequent events. In 1910 after the Senate joint resolution had passed the Senate and the House and it was already before the States for ratification, apprehension was voiced in some quarters that the amendment might be interpreted so broadly as to permit the Federal Government to tax the income of State and municipal securities. However, three outstanding and able Senators, namely, Senators Borah, Brown, and Elihu Root, took the pains, each upon a different occasion, to tell the Senate and the country at large, that the Senate joint resolution was never intended to extend the Federal Government's taxing power to the taxation of State and municipal bonds. The committee will recall that in the *Pollock case*, though the Justices dissented on all of the other grounds, they were unanimous in the conclusion that the Federal Government had no power to tax the income from State and municipal securities—instrumentalities of the States had been held immune. Senators Borah, Brown, and Root took the position that the amendment was not intended to extend the Federal taxing power to sources theretofore immune, i. e., the income from State and municipal bonds.

Senator Borah delivered a lengthy and eloquent speech upon the Senate floor. That speech has been reprinted in full as appendix A to the States' memorandum, and I trust that the committee will take opportunity to read it in full. I will not burden the committee with lengthy quotations from that speech, but will content myself with reading three short paragraphs from the Idaho Senator's summation. Senator Borah said:

> That the proposed amendment adds nothing to the taxing power of the National Government. This power was complete, unfettered, plenary before. It can be no more than that should this proposed amendment be adopted.
>
> The proposed amendment does not deal or purport to deal with the question of power which is already complete, but simply with the manner and method of exercising and using that power.
>
> The words "from whatever source" add nothing to the force of the amendment. It would, in constitutional parlance, be just the same if it said "to lay and collect taxes on incomes without apportionment," for who could then say that you would not have the right to lay taxes upon all incomes? The present taxing power would not be a particle stronger if it stated "to lay and collect taxes upon all property from whatever source."

Senator Brown, who introduced the amendment, fully supported Senator Borah's views. In a speech before the Senate, he said in part:

> I do not consider that the amendment in any degree whatever will enlarge the taxing power of the National Government or will have any effect except to relieve the exercise of that taxing power from the requirement that the tax shall be apportioned among the several States.

The third outstanding Senator to take this same view was Senator Root of New York. Senator Root took the pains to address a long letter to the New York State Legislature—because of its importance, this letter, too, is printed as appendix B to the States' Memorandum. Here again, I need not burden the committee with the reading of long quotations from Senator Root's letter. Suffice it to say that Senator Root explained:

The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax State securities or State instrumentalities. Nor can the State lay its taxing finger on Federal bonds or Federal agencies. Each is beyond the reach of the other as far as taxation is concerned. The proposed amendment is no sense seeks nor can it reasonably be argued to suggest any change in the independent or sovereign rights of either sovereignty as enjoyed and defined by the courts ever since the Government was organized.

Now, I should like to make this very significant point: After Senators Borah, Brown, and Root each took the pains to explain that the amendment was not intended to enlarge the Federal Government's taxing power, that it was not intended to permit the Federal Government to tax the income from State and municipal bonds—those views were never challenged, controverted, or questioned on the floor of the Senate or House. Quite obviously then, the explanation by these three able Senators fully allayed any fears which the States might have had regarding the possible interpretation of the amendment.

Under these circumstances I fail to see how anyone can reasonably come to the conclusion that the sixteenth amendment vests Congress with the power to enact such legislation as has been proposed. In my opinion that legislation can only be justified by ignoring the explanations of the amendment made upon the floor of the Senate by Senators Borah, Brown, and Root, and these explanations, I repeat, were never challenged, controverted, or questioned in Congress.

I might add in conclusion that the sixteenth amendment has been before the Supreme Court on a number of occasions, and the Court has steadfastly refused to interpret the amendment as granting Congress the power to tax subjects not theretofore taxable by the Federal Government. Those cases are likewise dealt with in extenso in the States' Memorandum (p. 344 et seq.), and I need not burden the committee with the discussion of that point. In addition to those cases which have interpreted the amendment, there are at least 22 cases in which the Supreme Court, before and after the ratification of the sixteenth amendment, has said in no uncertain language that the Federal Government may not tax the income from State and municipal bonds. (See the States' Memorandum at p. 120.)

In view of those circumstances, I respectfully submit on behalf of the State of Oklahoma the request that this honorable committee report to the Senate of the United States that the taxation by the Federal Government of State and municipal securities can be effectuated only by the adoption of a constitutional amendment.

The CHAIRMAN. Turn back in your statement. It seems to me that as to your statement as to the amendment finally adopted, that the construction placed upon it is one which could properly be placed upon it if it read Congress shall have the power to lay and collect taxes upon all incomes without apportionment among the several States, and without regard as to any census or enumeration, that is the amendment with the phrase, "from whatever source derived" deleted.

Now, what significance do you attach as to the inclusion of the phrase "from whatever source derived." I have not yet had an explanation of what the purpose was in putting that phrase in the Constitution.

Mr. WILLIAMSON. Senator, I would say from every aspect of it it has the appearance of taking out the more or less troublesome word, "direct," and insert therein the phrase, "from whatever source derived" in order to take away some troublesome construction which we know had theretofore been experienced by the court in deciding what were direct taxes.

The CHAIRMAN. Why not leave out the words "direct" or "indirect," and not substitute anything for it.

Mr. WILLIAMSON. Evidently someone felt they should substitute something when they took the word "direct" out. When they took this word "direct" out, nobody evidently suggested that they would leave that out and have the phrase "from whatever source derived." That means "direct" or "indirect."

The CHAIRMAN. To my mind I am almost ready to agree with the able argument Mr. Epstein made this morning, and the very excellent arguments made since then that the trend of decisions is decidedly against the Government's contention. You can dovetail them in together, and you can say that the courts have come to a conclusion on that point. I am a lawyer, but, speaking as a layman, it is difficult for me to read that language including that phrase, "from whatever source derived" without attaching some meaning to it. I do not think the people of the United States are bound by what Senator Brown, or Senator Root or Senator Borah thought was meant by the language. I think that the people of the United States are bound by the language inserted in this amendment, and I would be greatly enlightened for your argument, and the arguments from now on would be directed to clearing up that proposition, for I think that is the real question from a legal standpoint.

Mr. WILLIAMSON. I can only say, taking this opportunity in my final remarks to suggest that the gentlemen were somewhat troubled by the word "direct," and they took it from the resolution, and substituted these words thinking perhaps it would suffice.

The CHAIRMAN. I thank you for going into this question and I would like to hear more about it.

Senator AUSTIN. May I ask a question. It has been my impression that the word "direct" did not modify the word "income," and therefore, the deletion of the word "direct" did not affect the meaning of the word "income." You will note that the objective was to broaden the class of things taxable without apportionment. Therefore, does it not reasonably follow that the words "from whatever source derived" should be connected with the phases following them, viz: "Without apportionment", and so forth, rather than be treated as a substitute for the word "direct"?

Mr. WILLIAMSON. As I see it, the trouble with the word "direct" has been up before. The *Pollock case* had gone into that rather exhaustively some years before, and it occurs to me, and this is just my opinion, that one of the members of this Senate committee had in mind the history of the past, and the decisions of the courts in the past. They were hoping, no doubt, to obviate the difficulty, and no doubt to obviate this, and that they would arrive at a decision which would comport in upholding the constitutional amendment. It occurs to me they did it, and eliminated this word "direct," and used this other phrase which, in my judgment, they believed would be easier,

and more susceptible of a proper and constitutional interpretation without trouble than the use of the word "direct."

Senator AUSTIN. May I ask you another question. I am not challenging your views, but, asking for illumination. Do you believe by adding to the word "income," those words, "from whatever source derived" anything was done with that proposal to amend the Constitution that would make clear, that it included both direct and indirect taxes.

Mr. WILLIAMSON. I should say that they meant there to include the two taxes. I should say that it meant income from whatever source derived from what they discovered. I am inclined to think it probably did, but, they certainly wanted to get away in any event from the possible conception on the part of the courts that they were taxing directly. It occurs to me that they were wanting, if possible, to get away from the prior conception of the courts as to what constituted direct taxes, of course, without apportionment.

As I see it, that phrase constituted a crux of that whole amendment to the Constitution. That was the thing which empowered the Federal Government to move in and levy these income taxes as I see it.

Senator AUSTIN. If you tied those words, "from whatever source derived", to the following words, "without apportionment among the several States, and without any census or enumeration", I think you have no need for your argument.

Mr. WILLIAMSON. I should say there will be some consideration along that line.

Mr. TOBIN. May I suggest, if it is in point that we point out the interpretation placed upon the phrase by the Senator from Vermont. In the brief, page 339, there is the interpretation put upon it by Professor Seligman, than whom there is no more ardent supporter of the income tax, who said:

> * * * the amendment declares that an income tax can henceforth be levied without apportionment, no matter what the source may be, i. e., no matter whether the source is one that at present necessitates apportionment or one that at present does not necessitate apportionment. When the amendment states that the Government shall have power to levy a tax "on incomes, from whatever source derived, without apportionment," chief emphasis is to be put upon the words "without apportionment." The words "from whatever source derived" are indeed no mere surplusage. On the contrary their real import is to remove the existing discrimination between the various sources of income, so far as apportionment is concerned, and to put those sources which, under the existing interpretation, can be taxed only through apportionment in the same category as those sources which can now be taxed without apportionment. To say "from whatever source derived" is simply another way of saying "irrespective of the source," or a shorter way of saying "from all sources alike, whether the source be one that previously made apportionment necessary or not." So that the amendment is equivalent to the statement that "Congress shall have power to lay and collect a tax on incomes, whether previously laid by apportionment or not without apportionment." It is accordingly a mistake to assume that the words "from whatever source derived" give the Government the power to tax the income from State or municipal bonds, for such a tax falls within the third category of income taxes mentioned above as being entirely beyond the taxing power of the Federal Government.

There has been a suggestion that possibly they had in mind that the court would construe the word "income" as being income only from salaries or wages as distinguished from income from property, bonds, and so forth.

Mr. TOBIN. We believe that Professor Seligman's presentation on page 339 of the brief tends to show some light on the particular ques-

tion raised by you. The whole controversy as to the word "direct" has lasted in the court for several years.

The CHAIRMAN. Thank you very much, Mr. Williamson.

We will next hear from Mr. Thomas J. Herbert, attorney general of the State of Ohio.

STATEMENT OF HON. THOMAS J. HERBERT, ATTORNEY GENERAL OF THE STATE OF OHIO

Mr. HERBERT. Mr. Chairman, and gentlemen of the committee, I am appearing here as the attorney general of the State of Ohio, and I am taking the position followed by my predecessor, and the procedure taken by the Governor of Ohio, who was attorney general previous thereto. We are appearing here in opposition to the program of trying to accomplish those purposes by means of legislation rather than a member. We are convinced that the sixteenth amendment did not contemplate anything like it is proposing now.

As I read the Supreme Court precedents, Congress has no power to tax State and municipal securities. The entire question is whether the Supreme Court can be prevailed upon to change its interpretation of the Constitution in the absence of a constitutional amendment. This question then resolves itself into a matter of what we lawyers call precedent. Is the Court bound by its prior decisions? Should the Court be bound by its prior decisions: To what extent and in what circumstances will it disregard its own precedent? These are are the questions which must underlie our treatment of the legal problem before the committee.

Let us take up the first of these questions. Must the Supreme Court follow its own previous decisions? The answer is "No." There is nothing in our Constitution or in the rules of the Court which compels the Court to adhere to precedent. But the history of the past few centuries has made it a rule that our courts will always respect their prior decisions if it is at all possible. In other words, adherence to the precedent of decided cases is certainly the rule in American law.

There are very real reasons why that should be the rule. After all, law is little more than an outline of the rules which govern the daily conduct of men. If law is to have any value at all, there must be some way of knowing what it is. Stability in the law simply demands consistency.

Of course, that is not an inexorable demand. The courts will on rare occasions reverse previous decisions, but they have always made it clear that it is a very rare exception which only drastic necessity will induce the court to pursue.

But what are those drastic necessities which sometimes induce the courts to reverse themselves? The major ground as I see it is that sometimes it is found that the reason for a rule has ceased to exist. The corollary is that sometimes the customs of the community have so changed in certain sociological fields that the court will accept today what it felt could not be accepted 50 years ago. Those are the explanations for each of the cases or reversals to which the Department of Justice points.

But it must be evident that those reasons do not apply here. The rule of intergovernmental tax immunity is based upon the necessity

of preserving the balance between our State and Federal Governments. Certainly, there is no one here willing to argue that that reason no longer exists. Nor would anyone be willing to say that there would not be a clear dislocation of that balance of power if we should take annually out of the State and municipal treasuries over $100,000,000 for the sake of adding to the Federal revenues.

Chief Justice Marshall phrased it that "the power to tax involves the power to destroy." The Department of Justice is dissatisfied with Marshall on that point, although they are very anxious to accept his reasoning on certain other points which establish Federal immunity. But I think that that reasoning has as strong validity today as it ever had before. What is meant by "the power to destroy?" In behalf of the States, I submit that the States and their subdivisions are destroyed as such if they are stripped of the means necessary to carry out their essential functions of local government. The only purpose for government in a democracy is to serve its citizens. And we cannot do that if we are denied the revenues which are necessary to perform those services. In other words, take away a substantial portion of our revenues and you have to that extent destroyed our ability to function as States.

The validity of the reason as to the power to destroy cannot be considered any longer in vacuo. However important were the reasons of the Pollock decision of 1895, the importance of not changing the rule now without a constitutional amendment is even more important. Our decentralized democracy has evolved since then on the basis of that situation. If you suddenly change it, you will dislocate the revenues of our State and Federal Governments and unbalance our system. The passage of time has made it unimportant to speculate on the petty legal arguments as to how the case should have been decided. By now, legal speculation has turned into grim fact. You cannot change this rule without an actual disruption of the Federal system.

I know that Justice Holmes said that it is not necessarily true that "the power to tax involves the power to destroy." Of course, it isn't necessarily true. But I do not believe that Justice Holmes meant to discard Marshall's statement in its entirety. He never meant to suggest that a tax will be upheld if it is actually destructive. Reading both Marshall and Holmes together on this point, the true rule obviously is that the power to tax must be denied when it actually does involve the power to destroy.

Since the reasons for the adherence to precedent are exceptionally strong in this field, it is obvious that the Court should not be induced to scrap a century of precedent.

On behalf of the State of Ohio, I submit that an act to tax State and municipal securities is plainly unconstitutional. Some will say that I should then have no objections to its passage and the Supreme Court can decide for itself. I answer that it would be deplorable for Congress to show itself ready to disregard a rule of constitutional law which goes to the form of our government. I would consider it deplorable if a Congress should pass legislation in the field of intergovernmental relations which is clearly unconstitutional under the existing law. Whenever the Congress has passed acts of doubtful validity in the past, the doubt existed because there was no Supreme

Court decision directly on the point. That is not this situation where the Congress is being asked to pass an act which is obviously unconstitutional unless there is a reversal. In times such as these, I feel that Congress should set an example of respect for our Constitution and our form of government and should repudiate the suggestion that it should contribute, even by invalid legislation, to a disrespect of that Constitution.

If the committee please, I ask for a report against the validity of the proposed legislation. If considered necessary, the way is open to achieve the same result by a constitutional amendment, without setting any precedent for tampering with the balance between the States and the Federal Government.

The CHAIRMAN. Thank you, Mr. Herbert.

STATEMENT OF HON. FRANCIS A. PALLOTTI, ATTORNEY GENERAL OF THE STATE OF CONNECTICUT

Mr. PALLOTTI. Mr. Chairman and gentlemen of the committee, I appear before the committee on behalf of the State of Connecticut. I am proud to represent Connecticut, "The Land of Steady Habits," and to recall that just 300 years ago on January 14, 1639, the settlers of Hartford, Windsor, and Wethersfield and those along the banks of the Connecticut River united in the adoption of the first written constitution in American History, an event which stands unique of a self-governing people. It was a brave act in those times by which the people recognized themselves as "sovereign" and this, mind you, 148 years before the Constitution of the United States was written.

Connecticut never ratified the eighteenth amendment to the Constitution of the United States and Connecticut was right for the eighteenth amendment was repealed by the twenty-first amendment to the Constitution.

The sixteenth amendment to the Constitution—the amendment now in question before your committee—was never ratified by Connecticut, and taking into consideration the disputes and misunderstandings that have now come up as to what is meant by the sixteenth amendment I am prouder than ever that I come from Connecticut. Connecticut, being law-abiding and upholding the Constitution, recognizes that the sixteenth amendment is the law of the land, but Connecticut emphatically disagrees with the effect, purpose and intent that is now being attempted to be placed on the sixteenth amendment. I am certain that nearly all the other States in the United States would never have ratified the sixteenth amendment if, for one moment, they had the slightest idea that Congress would attempt to do something that the sixteenth amendment never intended to do.

As attorney general for Connecticut I would like to discuss certain of the legal arguments made by the Department of Justice which my State does not approve iof.

Connecticut, as usual, was one of the first States to see the patriotic necessity of compelled action to combat these Federal proposals to tax the States whether they liked it or not. My predecessor in office, Hon. Charles J. McLaughlin, now State tax commissioner, was one of the organizers of the Conference on State Defense and has been serving as vice chairman of that association through which State and municipal officers are cooperating in the presentation of the States' case.

My office has consistently taken the position that the Federal Government does not have any constitutional power whatsoever to tax a single bond of the State of Connecticut, or any other State. Attorney General McLaughlin ruled last August that a $25,000,000 bond issue we floated then was beyond the Federal taxing power. I held that view before I read the Department of Justice study. And, after reading the very best arguments which the Department of Justice is able to dig up, I am more firmly convinced than ever that State and municipal bonds are absolutely immune. Hardly an argument is made which does not fall apart under analysis. Hardly a case is cited which does not bolster up rather than weaken the immunity of Government bonds.

But there is one particular problem to which I should like to direct my remarks especially. I want to show how completely in error the Department of Justice is when it argues that its tax plan is fair and reasonable because it gives the States the same right to tax Federal securities as it claims for the Federal Government in taxing State obligations.

The Department of Justice and the Treasury Department tell us that there is nothing for us to worry about in Federal taxation of our State and municipal bonds, since they are willing to give the States the "reciprocal" right to tax Federal securities. That, we are told, should eliminate any objection which the States have. It is offered as a magnificent gesture that puts the whole proposal on a high plane of fairness and equality.

Before this committee, I say that those apologies and excuses for this plan are utterly absurd. The plan is not fair. The plan is not reciprocal. The plan gives the States no equality whatsoever.

We in Connecticut are told, Mr. Chairman, that we may tax the income on Federal bonds. But we have no personal income tax in Connecticut. In other words, for all practical purposes, we are not to share in this so-called fair way of avoiding discrimination. The plan will cost our State and municipal governments over $1,500,000 in extra interest cost every year. And, aside from the little we might get from our corporations, my State is not to get a single cent in return by taxing Federal bonds. In that respect we in Connecticut are not alone. Sixteen States in the Union do not have a personal income tax. Just where do we fit into this picture of statutory reciprocity?

And then there is the case of our municipalities and even the municipalities of the States which do have an income tax. Connecticut cities and towns would have to pay an additional $1,000,000 a year in higher interest if the Federal Government should ever succeed in taxing our bonds. Not one of our municipalities and, indeed, not one of the municipalities of any other State in the country would have any way of taxing the income on Federal bonds.

Mr. Chairman, I know of many small towns and villages and school districts in my State which must shortly issue bonds and to which even a few thousand dollars in additional interest cost would be a calamity. And in many of them there probably is not even a single holder of Federal bonds against whom a local tax might be levied. Of course, that applies on a larger scale even among the States. Many States have very few holders of Federal bonds within their borders. As a practical matter, they are powerless to get back a single cent in taxation of Federal securities even if they should happen to have an

income tax. In other words, they too are not to share in this so-called equality and reciprocity.

However, those points are largely fiscal rather than legal. And the legal objections to this so-called fair and equal plan are just as powerful. The Department of Justice says that the Federal Government has a constitutional power to tax the bonds of my State or of any other State in the Union. But they claim that it would take an amendment to the Constitution for the States to tax Federal bonds, unless the Federal Government consents by statute. But so far as the States are concerned, the Department insists that it does not make a bit of difference whether the States are willing to give their consent to Federal taxation or not. Even without a constitutional amendment and even without their consent, the United States Attorney General says the Federal Government may tax us and our bonds. In other words, the Federal Government is to have an absolute right to tax the States; the States are to have a permissive right to tax whatever Federal instrumentalities the Federal Government will deign to permit and only so long as the Federal Government will deign to permit it.

But the committee must see that if we in the States have no constitutional protection against any Federal taxation, as the Department of Justice argues, then there is no constitutional objection to any Federal taxation of our property, our functions, and our revenues. Nothing in the Constitution would be left to make a future Congress stop only with our future bonds. And what are we to get in return? Only a very limited waiver of the Federal immunity. In other words, if this bill were ever upheld, the Federal Government would be able to tax anything of a sovereign State and the States could only tax whatever it happened to please the Congress of the moment to allow.

If the permission to the States to tax Federal income could be given by this Congress, it could be repealed by any subsequent Congress. If the Federal Government has a constitutional right to tax the States, it could do so even if a subsequent Congress repealed the permission to the States to tax Federal income. It would not make any difference that you gentlemen and the Members of this Congress would agree that that would be a terrible injustice. The constitutional bars would be down.

Then there is a similar point. The President of the United States, the Department of Justice, the members of this committee, and the attorneys general of the States all agree that there must never be any taxation of the already issued exempt State and municipal securities. That could not be done in good conscience because it would be a breach of faith. But, Mr. Chairman, this whole Department of Justice plan is based on the legal assumption that the United States has the power to tax any State and municipal bond, outstanding as well as future. And if this bill were constitutional, any future Congress could come along and impose a tax on any outstanding State and municipal securities even though they were issued before this bill and even though they were sold with the absolute understanding that they would never be taxed.

Now, I believe there is not a man on this committee who would think of allowing Federal taxation of State securities without giving the States permission to tax Federal securities. There is not a man on this committee who would not consider it a grievous injustice to continue taxing State securities after the permission to tax Federal

securities was repealed. There is not a man on your committee who would tolerate the taxation of outstanding exempt securities. But have you gentlemen, or any other Members of the Congress, the power to bind and commit your successors to any policy which you think is fair? Who can say whether a future Congress could not devise a plausible "emergency" either for withdrawing or limiting the permission to the States to tax certain Federal income while continuing to tax the States? And if this Congress attempts to assert the power to tax the States, who can tell whether a future Congress will not employ that power to tax the outstanding bonds and even the State revenues and property?

The States believe that the Department of Justice does not contemplate any of these distortions of the so-called reciprocity and equality which they urge. The States have the utmost confidence that no Member of this Congress would tolerate the exercise of such powers. But the powers would be there. And it is a truism, Mr. Chairman, that the possession of a power invites its exercise. Especially when it is a power to raise revenue by taxes.

This is not a matter of trust, this is a matter of constitutional right. The answer was given 120 years ago by Chief Justice Marshall in *McCulloch* v. *Maryland*. The great Chief Justice asked: "But is this a case of confidence? Would the people of any one State trust those of another with the power to control the most insignificant operations of their State government? We know they would not. Why, then, should we suppose that the people of any one State should be willing to trust those of another with a power to control the operations of a government to which they confided the most important and most valuable interests?"

Gentlemen of the committee, on behalf of Connecticut and the other States of the Union similarly situated, I say that this statutory "reciprocity" is no reciprocity at all. It is inserted in this proposal to give it a semblance of fairness. But it is clear that under it, the States would not have the faintest chance for equality.

A statute cannot give real reciprocity and it cannot give real equality. The only way the States can be protected is by a constitutional amendment. If they consent to a constitutional amendment, their sovereignty is not violated. And if a constitutional amendment restricted the power of the Federal Government to the taxation of their bonds, they would never face the prospect of being called on to pay taxes upon their revenues and property. Finally, if a constitutional amendment gave the States and the municipalities a reciprocal power to tax Federal securities no subsequent Congress would ever be tempted to repeal the reciprocal provision and destroy the equality contemplated.

I submit, Mr. Chairman, that a statute along the lines of that proposed by the Department of Justice is a tremendous step toward the end of State independence and our Federal system. If the people of the United States wish to change the form of their Government, they are free to do so. However, the lesson of too many fallen democracies in other lands should keep us from taking any step in the direction of changing the form of our government without the constitutional permission of our people. I thank God that in America the people still rule.

The CHAIRMAN. Thank you, Mr. Pallotti.

I have a telegram from the Governor of Connecticut, Raymond Baldwin, emphasizing his views which we will have inserted in the record.

The telegram is as follows:

I want to be recorded as opposed to any Federal tax on State and municipal bonds. The proposal to tax State and municipal bonds places a tax upon a tax and is an unconstitutional exercise of the Federal taxing power.

RAYMOND BALDWIN,
Governor of Connecticut.

I have a telegram from the Governor of Vermont, which reads as follows:

I am opposed to any Federal taxation of income from State bonds unless the States are given the right to tax the income from Federal bonds.

GEORGE D. AIKEN,
Governor of Vermont.

I have a telegram from the Governor of Wyoming, which reads as follows:

The State of Wyoming is strongly opposed to Federal tax on State bonds. Wyoming desires to be recorded among those States opposing this Federal measure.

NELS H. SMITH,
Governor of Wyoming.

I have a telegram from the Governor of Arkansas, which reads as follows:

Federal tax on Government bonds will constitute an exaction from the State of Arkansas by the Federal Government. The State of Arkansas owes more than $140,000,000 which must be refunded. Legislation cannot be shaped to nullify natural loss. Consequently upon sale of refunding bonds the State would inevitably be required by purchasers to absorb the tax in less favorable interest rates or discounted purchase prices. We strongly oppose such a measure.

CARL E. BAILEY, *Governor.*

STATEMENT OF HON. JAMES R. MORFORD, ATTORNEY GENERAL OF THE STATE OF DELAWARE

Mr. MORFORD. Mr. Chairman and gentlemen of the committee, if the committee please, I am appearing on behalf of the State of Delaware, in my official capacity as the Attorney General of the State, to protest, both on constitutional and economic grounds, against the proposal to subject State and municipal bonds to Federal income tax. Prior to my election as Attorney General of Delaware, I served as city solicitor of the city of Wilmington for 3½ years.

When the Treasury Department first issued its study on June 24 1938, in which it was claimed that the Federal Government has a supreme power to tax the States, my predecessor, Hon. Percy Warren Green, immediately directed his staff to give the subject study commensurate with its danger to the fundamental interests of the State. After thorough research, the office of the Attorney General concluded that the Treasury's legal arguments in support of its contention were entirely in error.

Our reasons for so thinking are embodied in the legal brief which has been submitted to the committee, in the presentation of which I have joined.

We submit that the Supreme Court has not deviated from the time-honored and time-tested rule of reciprocal immunity from taxation

and that the ancient aphorism "the power to tax is the power to destroy" has lost none of its compelling force. Rather has the trend of events emphasized its soundness.

The case of *Helvering* v. *Gerhardt*, 304 U. S. 405, upon which the Treasury seems to rely very largely relies to support its position that a congressional statute taxing State and municipal bonds would be held constitutional, did not, we think, hold or decide any such thing. Far from indicating that Congress had such power, the Court expressly referred to the *Pollock case*, which is the case holding State and municipal bonds immune from Federal taxation, in support of its reasoning. The Department of Justice itself, at page 61 of the study, concedes that the "*Pollock case* has been decided and it has not yet been overruled." It is interesting to note the statement following. The study states, "At least in the field of inter-governmental tax immunity, this is not a matter of great importance." That is the first time in my experience as a lawyer that I have ever known of an attorney advising a client that a ruling of the Supreme Court, cited with approval innumerable times, is "not a matter of great importance."

However, while conceding the fact that the *Pollock case* has not been overruled the Department of Justice contends that there is a "trend" toward the complete elimination of inter-governmental immunity as far as the States are concerned. But in the very cases that the Department of Justice relies upon to show this "trend" against bond immunity, there are definite and strong statements showing that the *Pollock case* is still authoritative. At the very last term of the Court no less than four direct utterances of the Supreme Court upheld the immunity of State and municipal bonds from Federal income tax.

May I refer very briefly to those cases. In *Hale* v. *Iowa State Board*, 302 U. S. 95 (1937), Mr. Justice Cardozo said:

> By the teaching of the *Pollock case* * * * income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing.

In *James* v. *Dravo Contracting Co.*, 302 U. S. 134 (1937), Chief Justice Hughes said:

> The ruling in *Pollock* v. *Farmers' Loan & Trust Company*, 157 (U. S. 429), related to net income, the uniform ruling in such a case being that the interest on Government securities cannot be included in a gross income for the purpose of a tax on that income.

Again in *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376 (1938), the Chief Justice repeated that a tax upon

> the interest payable on State and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government,

citing for that proposition *Pollock* v. *Farmers' Loan & Trust Company*. And finally in *Helvering* v. *Gerhardt*, 304 U. S. 405 (1938), which the Department of Justice contends has opened the door to the taxation of State and municipal bonds, Mr. Justice Stone wrote concerning the immunity of such bonds:

> It (the immunity) has been sustained whereas in *Collector* v. *Day* the function was one thought to be essential to the maintenance of a State government; as where the attempt was * * * to tax income received by a private investor from State bonds, and thus threaten impairment of the borrowing power of the State.

again citing *Pollock* v. *Farmers' Loan & Trust Company*.

In the brief which we have submitted to this committee on behalf of attorneys general of 39 States we show that the *Pollock case* has been expressly cited with approval ever since it was decided, no less than 21 times. A list of these cases appear on page 120 of the brief which has been filed before your committee. We say, therefore, that if there is any "trend" to be discerned it is one, not toward the abolition of bond immunity or reversal of the *Pollock case*, but rather one showing clearly that the *Pollock case* is still the law of the land.

We contend that favorable action on the Treasury's recommendation here would, if upheld by the courts, be a Federal compromise of the States' position as sovereign governments. Of course to those who believe in the centralization and nationalization of our Government, this, too, I presume, is not a matter of great importance, but to us, who still believe that the States are the most perfect expression of our democratic institutions, and that local government is not only able, but is most fitted, to handle local affairs, it is a serious matter.

This country was founded, and still exists, on the principle that it was a federation of States, comprising in effect, independent nations who retained the full power of sovereignty, subject only to the exercise of certain delegated powers, which for the common welfare they had ceded to the Central Government.

The framers of the Constitution never intended to set up a supreme central government, and to my knowledge, never until this day have proposals been advanced that open the way to such a result. The entire body of our constitutional law, as interpreted by the Supreme Court and experts in that field, rests on a diametrically opposite basis.

Nor did the adoption of the sixteenth amendment destroy this constitutional concept. It is amazing to think that by the adoption of an amendment containing the slightly ambiguous words "from whatever source derived" we are now said to have overturned our entire governmental structure, and set up a new structure of government. Well may we quote the words of Senator William E. Borah in a recent letter to the Conference on State Defense:

> To construe the proposed amendment so as to enable us to tax the instrumentalities of the State would do violence to the rules laid down by the Supreme Court for a hundred years, wrench the whole Constitution from its harmonious proportions, and destroy the object and purpose for which the whole instrument was framed.

The State of Delaware protests the proposal also on economic grounds. In the year 1937, there was paid by the various governmental units, that is, State, municipal and other local instrumentalities, about the sum of $1,106,000 in interest on bonds. If these bonds are made subject to tax there would in all likelihood have been an increase in cost to the State of Delaware as a whole, of more than a third of a million dollars.

While, perhaps, this sum does not seem large, it should be remembered that Delaware prides itself on its low cost of government. The addition of this amount to the various governmental budgets would have a tremendous effect on our tax rates. In the case of the States alone, if the difference were to be made up by an increased income tax, it has been estimated that the rate would go up 16.4 percent.

The position of the State of Delaware on this question bears additional weight, because the proposed statute would include a permis-

sion to the States to tax Federal securities. Through such permission it is quite probable that the State of Delaware would come out ahead on the transaction, since we believe that there are considerable holdings of Federal securities which would be subject to the taxing power of the State. But even though we might stand a possible chance to break even, were such a statute to be enacted—and subject to the obvious contingency that it might at any time be repealed by the Congress—we are nevertheless unqualifiedly and absolutely opposed to it.

We believe the proposed statute is entirely unconstitutional. Its passage would be an assumption of a national power over the States which cannot be tolerated. Moreover from the economic viewpoint, the Nation as a whole suffers severely. Many States and most municipalities, particularly the city, would be hard pressed to meet the added cost which such a tax would place upon them.

The State of Delaware, therefore, urges that this committee report to the Senate that the proposed statute is both constitutionally and economically unsound.

Senator AUSTIN. May I ask a question? There is a statement in the study by the Department of Justice as follows:

> More graphic evidence could not be presented as to the essential fairness of the Federal tax, and as to its inconsequential effect upon the operations of the Government.

I ask you, who seem to have the opinion that your own State might break even, whether that effect generally over the State would be inconsequential so far as the operations of government go, there is the effect of increasing the cost of operations.

Mr. MORFORD. I do. It would increase the cost of the operations of government, particularly with municipalities.

Senator AUSTIN. Do you think it would be inconsequential?

Mr. MORFORD. I do not think it would be, so far as the municipalities are concerned. I think that so far as the State and county governments are concerned, and of course, I am speaking only for my own sake, I think the State and counties would be better off financially but, without municipalities, where they depend entirely for the revenue to meet bond issues upon a real-estate tax, that the situation would be a particularly serious one. As I understand, it has been estimated by economists to have been given a great deal of thought and study to the subject that the interest rate upon which new bonds would be issued by municipalities throughout the country will be increased by approximately six-tenths of 1 percent. That alone is a tremendous figure in considering the cost of local government.

The CHAIRMAN. Thank you, Mr. Morford.

We will next hear from Assistant Attorney General Rice of Utah.

STATEMENT OF HON. JOHN D. RICE, ASSISTANT ATTORNEY GENERAL OF THE STATE OF UTAH

Mr. RICE. Mr. Chairman and gentlemen of the committee, I represent Attorney General Joseph Chez, of the State of Utah. With the committee's permission I would like to discuss very briefly some of the constitutional aspects concerning the proposals of the Federal Government to tax State and municipal securities.

This committee has already heard, through the Honorable O. F. McShane, Industrial Commissioner of the State of Utah, of the economic effects of such a tax upon local government in my State. I shall, accordingly, concern myself solely with legal argument.

Other attorneys general have already discussed before this committee the legislative history of the sixteenth amendment. They have shown that the history of the amendment does not square with the contentions advanced by the Department of Justice in support of the proposition that Congress already has the constitutional power to tax State and municipal securities.

Those of us who are lawyers know that law is one of the cornerstones of organized society and that if laymen generally are to respect it, there must be some way of knowing exactly what the law is. In this country and in England, that fact has been recognized and the courts have, for three centuries, imposed upon themselves the duty of respecting their own prior decisions. I do not intend, however, to advance the position that the Supreme Court of the United States should not be free to reverse itself in certain fields. Indeed, I believe that where broad questions of social policy are involved, the Court should, as it now does, feel free to hold that a minimum-wage law, for example, is constitutional, notwithstanding the fact that some years prior it had held such a law unconstitutional.

However, I can imagine no single field of law, constitutional or otherwise, in which the reasons for adherence to prior decisions apply with greater force than in the field of the fundamental relationship between the States and the Federal Government. We all know how unique our American form of government is; it is a combination of coordinate State and Federal sovereignties. The preservation of the delicate balance between these two sovereign governments is something which will always constitute one of the most difficult problems for our statesmen and our courts. Indeed, the Supreme Court of the United States has itself recognized the difficulty of preserving this balance (*South Carolina* v. *United States*, 19 U. S. 437, 448). The doctrine which the States are here defending goes to the heart of our dual form of government under the Constitution. In these days when the forms of government are being destroyed in countless lands abroad there cannot, in my opinion, be any more important question than the preservation of our basic form of balanced government. These then are ample reasons why we should, wherever possible, respect Supreme Court decisions. Now then what are these decisions?

The first case involving the sixteenth amendment to reach the Supreme Court was *Brushaber* v. *Union P. R. Co.* (240 U. S. 1, 1916). In this case the Supreme Court denied what the Department of Justice now contends—that the sixteenth amenament constituted a new grant of power. Thus, the Court said:

> It is clear on the face of this text that it does not purport to confer power to levy income taxes in a general sense—an authority already possessed and never questioned, or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived.

The Department of Justice now takes the view that the amendment was adopted to give Congress power to tax State and municipal bonds—a power concededly not had before. The Supreme Court,

however, did not think so in the *Brushaber case*. Former Under Secretary of the Treasury Magill has said of this case:

> Mr. Chief Justice White went out of his way to state and elaborate this conclusion —
>
> that the—
>
> amendment did not extend the taxing power to new subjects.

In the language of the Supreme Court in the *Brushaber case* —

> * * * there is no escape from the conclusion that the amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock case* was decided; that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment. * * *

I should like to point out in passing that as the Court observed in its opinion, it examined both the history and circumstances surrounding the adoption of the amendment. Also that the members of the Court who studied the history of the amendment in the *Brushaber case* were fully familiar with the circumstances surrounding the adoption of the amendment. The statesmen of that day were their contemporaries and associates.

The next case before the Court was *Stanton* v. *Baltic Mining Co.* Here again in contrast to the Department's assertions of a new power, the Court said:

> * * * the provisions of the sixteenth amendment conferred no new power of taxation, * * *.

Peck & Co. v. *Lowe* (247 U. S. 165, 1918) was the next important case. It is especially significant because here again the Court had before it the historical background of the amendment. Thus, the taxpayer's brief specifically cited and quoted Senator Borah's and Senator Root's opinions. Giving due consideration to these views, a unanimous Court said:

> * * * As pointed out in recent decisions, it [the sixteenth amendment] does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another [citing the *Brushaber* and *Stanton cases*].

The Department of Justice in a strained effort to get away from this positive obstacle to their case, says (Department of Justice Study, p. 209) the Court "does not correctly interpret the language used by Mr. Chief Justice White in the *Brushaber* and *Stanton cases*." From this I must, of course, dissent. A careful reading of the *Brushaber case* shows that the Court's interpretation of the case was sound and consonant with what Chief Justice White said therein. A careful reading of the Department of Justice Study fails to convince me that they have found any error in the *Peck case*.

As opposed to their charge that the Supreme Court did not interpret the *Brushaber case* correctly, I need only point out that as recently as 1925 the Supreme Court, in a unanimous opinion said (*Metcalf* v. *Mitchell*, 269 U. S. 514, 521):

> * * * the sixteenth Amendment did not extend the taxing power to any new class of subjects, *Brushaber* v. *Union P. R. Co.*, 240 U. S. 1, 60 L. ed., 493; *William E. Peck & Co.* v. *Lowe*, 247 U. S. 165 * * *.

In *Willcutts* v. *Bunn* (282 U. S. 216, 1931) a unanimous court again said, after the adoption and ratification of the sixteenth amendment:

> In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations (*Pollock* v. *Farmers' Loan & T. Co.*, 157 U. S. 429, 586, 39 L. ed. 759, 820, 821, 15 S. Ct. 673, supra). These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government.

And so I could go on and cite to the committee such cases as *Eisner* v. *Macomber*, 252 U. S. 189, 1920; *Evans* v. *Gore*, 253 U. S. 245; *National Life Insurance Co.* v. *U. S.*, 277 U. S. 508, 1928. All of these were decided after the adoption and ratification of the amendment and all of these contain clear expressions of opinion which are directly contrary to the views offered by the Department of Justice in their study. However, all of these cases are fully discussed in the States' memorandum and, accordingly, I shall content myself at this point with pointing out the following significant facts:

1. The history of the amendment has already been before the Court. It has already examined the message in which Governor Hughes then of New York expressed the fear that the amendment might be interpreted so as to permit a Federal tax on State and municipal bonds, the Court specifically rejected that interpretation in favor of the assurances by Senators Borah, Root, and Brown, to the Senate and the Nation, that the amendment was not intended to permit such a tax. The Department nevertheless urges another opportunity to present the history of the amendment to the Court.

2. Taking part in some of the leading cases in the interpretation of the amendment were Mr. Chief Justice White and Mr. Justice Sutherland and the present Chief Justice Hughes. Each one of these Justices was, or is, peculiarly fitted to interpret the amendment in the light of contemporary history. Each has at one time or another had opportunity to interpret the amendment as the Department of Justice suggests it should be interpreted. Each has joined his brethren in holding that the amendment did not vest Congress with power to tax subjects theretofore immune. The Department nevertheless urges another opportunity to present the history of the amendment to the Court.

3. Former Chief Justice White who had been all through the *Pollock cases* was the first to say that the amendment did not constitute a new grant of power. The Court subsequently accepted that statement and made it the basis of the *Peck case*. That view has been concurred in by a unanimous court in a subsequent case in the *Metcalf case*.

4. There are many cases in which the Supreme Court, before and after the ratification of the sixteenth amendment, has said in no uncertain language that the Federal Government may not tax the income from State and municipal bonds.

From all of which it will be seen that the Department hopes that if Congress will but add the weight of its action to the study and if it can have just one more chance it will convince the Court that all of its prior decisions and statements of the rule of State immunity are wrong. Just how the Department would accomplish this complete reversal of precedent is not clear--certainly they have failed to make out a case that the prior decisions and statements of the rule are

wrong. Of course, it may be that the Department hopes it can convince the Court that all their prior reasoning has not been consistent. But under these circumstances the States submit that legislation which is clearly unconstitutional should not be passed.

I should say that in our own State of Utah the Supreme Court has interpreted this language, "from whatever source derived," in a case found in 79 Pac. (2) 6. I will not take time quoting from it. It is the *Ferrell case* decided on February 9, 1938. It was held in that case that the Constitution gave the National Federal Government the right to use delegated powers, and also the State governments capable of exercising them, essentially both operations within the same territory limits. Therefore the Constitution itself makes adequate provision for preventing conflicts between them.

There, you have the *Brushaber case*, and the *Ferrell case* decided in 1938, and it seems to me that the phrase, "from whatever source derived" has been adequately determined.

I thank you.

The CHAIRMAN. I thank you, Mr. Rice.

We will now hear from Attorney General George Couper Gibbs, of Florida.

STATEMENT ON HON. GEORGE COUPER GIBBS, ATTORNEY GENERAL OF THE STATE OF FLORIDA

Mr. GIBBS. Mr. Chairman and gentlemen of the committee: As attorney general of Florida, I wish to place Florida in line with the other States as opposed to the passage of any legislation at this time, for two reasons: First, because we believe, as we have pointed out in our brief, and I will not encumber the record by a repetition, that such a statute would be unconstitutional.

Second, for the economic reason that Florida, suffering so greatly both from storms and financial depression, has found it very difficult to come back again.

We now have some $450,000,000 of bonds outstanding. Some, I regret to say, are in default, and many are in the course of refunding.

If we have to add to the present burden the additional burden of six-tenths of 1 percent, it will be very hard for the municipalities, the counties, the school districts, and the drainage districts, to refund these bonds.

Through the generosity of the Federal Government, we are erecting schools. We are raising part of this money by virtue of bonds. If even a small amount were added to it, it would make it impossible.

I feel that the education of our children and the furtherance of the greater interests of the State, and when I speak of my State I mean that my State takes its place, along with the other States, in its opposition to any increased taxation.

If, in the wisdom of Congress, you see fit to propose a constitutional amendment, I am quite sure that, if the States consent to a constitutional amendment, we will endeavor to pay the tax.

As to the question just raised, and the argument, it seems to me that there might be another reason, that the construction that has been placed was the construction that has been pointed out by Mr. Tobin, because, if there had been any other construction, there might have been an attempt by Congress to lay tax.

The fact that Congress never sought until this time to lay this tax, as stated by Mr. Tobin, was the view of Congress at that particular time and the people's assent.

You know those constructions, when they come up before a court, are entitled to great weight.

I thank you, gentlemen, and it is unnecessary to go any further.

The CHAIRMAN. I thank you, Mr. Gibbs.

We will now hear from three city attorneys; Mr. G Coe Farrier, assistant city solicitor of Philadelphia; Mr. Guy Hutchinson, of Jacksonville, Fla.; and Mr. Julian W. Barnard, of Norristown, Pa.

We will now hear from Mr. Farrier.

STATEMENT OF G. COE FARRIER, ASSISTANT CITY SOLICITOR, PHILADELPHIA, PA.

Mr. FARRIER. May it please the committee: I am here on behalf of S. Davis Wilson, the Mayor of Philadelphia, and for him I speak for 2 percent of the population of the United States, and perhaps 5 percent of the invested wealth of the United States.

The city of Philadelphia has $537,000,000 of bonds outstanding now. Those bonds, every one, carry a covenant that all imposed on the same after their issuance shall be paid by the city, or reimbursed to the investor for any tax he might have to pay.

Under those conditions, a 4 percent tax, imposed retroactively upon our presently issued bonds would result in the imposition of $18,000,000 additional tax upon our real property in the city.

Now, we know that is a prohibition against the Federal Government levying direct taxes, except under certain conditions. I think that prohibition extends to situations like ours, where you have a situation that the direct result of the proposed legislation would be the immediate imposition of $18,000,000 additional levy upon the city of Philadelphia.

Now, on the other hand, if the legislation you recommend is not intended to be retroactive but only prospective, I can say to you that the city of Philadelphia has $400,000,000 outstanding of serial bonds, which can be refunded at the end of 20 years or any interest-paying period thereafter. They are 50-year bonds. These bonds are paying anywhere from 4½ to 5½ percent interest, and some of them are bringing $134 on the open market today on $100 par.

If there is legislation, prospective in its nature, that imposes, upon our right to refund these bonds, a 4 percent tax, you have got about $16,000,000 laid under the property when we desire finally to refund these bonds.

That is our situation, concretely, on this proposition.

I say to you gentlemen that the tax proposed to be imposed may have a very grave purpose, and, representing Mr. Wilson, I wish to say there is not a more liberal man in the United States than he is, and I am not here imposing President Roosevelt's ideals. We are satisfied to render unto Caesar the things that are Caesars, but we want to find out what belongs to Caesar before we believe in any such legislation.

I say that this proposition, worked to the extreme of the Treasury, is almost cannibalisitc. It is the absorption by the Central Government of anything that has any economic value in the political subdivisions of the State.

Now, the Attorney General has submitted to you a brief, his White Book. I do not want to go into the law on this proposition. I could very easily do so.

But I do say, however, after reading the Attorney General's brief, that there is only one law that he has invoked that should have any influence with you, and that is the law of necessity. Necessity knows no law, and if there is necessity for this tax, you can do, as has been done from the beginning of time, impose any kind of tax you please and get away with it, if there is a necessity for it.

Now, I do not believe that there is any necessity, as you will find from this hearing, in going through the transcript, and you would not be Senators if you did not have powers to analyze such situations.

I have not heard anybody say a word about the tax upon municipal employees. That, I think, is as vital as the other.

Now, let me ask you to consider one thing, and that is this: Municipal and State employees are not protected by any labor laws. They cannot privately organize. They cannot strike. They cannot have a vote, and they cannot do anything but lick the boots of their political bosses.

I say to you gentlemen from my own knowledge from a study of the conditions throughout the United States, and I do not get this out of books, but I say that the municipal employees of the cities of the United States are the poorest paid people who work for a living in the United States today.

As to the W. P. A. workers, and I can show you absolutely with a table, if you care to have it put in the record, from my own analysis of the 21,000 employees of the city and the county of Philadelphia.

Senator AUSTIN. I suggest that we have that added to the record.

The CHAIRMAN. Can you supply it?

Mr. FARRIER. I can supply it to you within a week.

The CHAIRMAN. Within a week?

Mr. FARRIER. Would that be too late?

The CHAIRMAN. I am a little afraid it would be.

Mr. FARRIER. I can get it to you by Tuesday.

The CHAIRMAN. We will be very glad to have it.

(Subsequently a letter was received from Mr. Farrier which will be found at the conclusion of his testimony.)

Mr. FARRIER. Now, I wish to go to another point.

Take myself, for instance: I am in what may be called the higher bracket. I am the sole support of 16 people. I have $11,000 a year exemption before I owe any taxes at all, and I get $5,000 a year, and, therefore, you can see that I am not personally concerned in this question. I have not filed any income tax return for years. I do not have to.

But, to take the practical side of it, the income-tax law says that if you have a deductible income, you have to file an income-tax return; if you have a returnable income, you have to file an income-tax return.

The tax is imposed upon these municipal employees, and if the income earned by the employee is returnable, he must file a return, not for the purpose of paying a tax, and you can see the condition that would arise with the 21,000 employees in Philadelphia. That has to be considered as a practical side of this question.

The next thing is, and this is also a practical proposition: As I say, I represent one of the higher brackets of Philadelphia public employees.

As I have shown you, I will pay no tax under any conditions, unless you propose taxes to the last dollar. I would say to you that there is not one in a thousand of the employees of the city that would ever pay the Government a nickel on income from the city.

These are things that have to be considered. You have to be practical, and if you are going to be practical, I say to you that there is no reason to levy a tax on municipal employees, and that it will be love's labor lost.

(The letter previously referred to from Mr. Farrier is as follows:)

FEBRUARY 13, 1939.

Hon. PRENTICE M. BROWN,
Senate Office Building, Washington, D. C.

DEAR SENATOR BROWN: I am forwarding to you under separate cover copy of a report prepared after an exhaustive examination, with respect to the standard of wages in the municipal government of Philadelphia, as requested by the Special Committee on Taxation of Governmental Securities and Salaries, pursuant to Senate Resolution No. 303, Seventy-fifth Congress. The report is taken from "City of Philadelphia: Classification and Compensation Plans of the Personal Service in the Executive Departments;" approved by the Civil Service Commission October 1930; prepared under the direction of the Civil Service Commission by J. L. Jacobs & Co., of Chicago.

You will note that on page 6 of this report it is shown that the employees of Philadelphia number 22,048 and that the total salary items amount to $33,600,000. This analysis shows that the average salary of municipal employes of the city of Philadelphia is $1,523 per year. It is patent from a consideration of this figure that with existing exemptions and allowances that very few of these employes would fall into the income-tax-paying class. In addition, these employees have no tenure of office, have no right, under existing laws, to collective bargaining and are not eligible for protection under the Federal social-security laws. When it is considered that each one of these employes is subject at all times to the vicissitudes of politics, it is hard to understand why it is considered that they fall into the same class as employees in industry and commerce.

I desire to point out that while the Jacobs report relates to a period for the year 1930, that wage conditions in the city of Philadelphia, insofar as they relate to municipal employees, have become worse rather than better, and economic conditions have been such that the beneficial recommendations of the Jacobs report have not been put into effect.

The brief filed on behalf of the attorneys general of the States and counsel for certain of their municipal subdivisions, while it is directed to the constitutionality and legality of imposition of taxes on income derived from municipal securities, is equally applicable to render the collection of taxes from income derived from services rendered to State or municipal governments invalid.

The power of the Federal Government to interfere with the internal management of the State governments is withheld by the very structure of our form of government and the Constitution, and the imposition of taxes on State and municipal salaries is equally repugnant to the constitutional provisions and all constructions placed thereon by the Federal Supreme Court.

Thanking you for the hearing given me last Friday, I remain,

Yours respectfully,

G. COX FARRIER,
Assistant City Solicitor.

The CHAIRMAN. I thank you, Mr. Farrier.

We will now hear from Mr. Gov Hutchinson, of Jacksonville.

STATEMENT OF GOV HUTCHINSON, CITY SOLICITOR, JACKSONVILLE, FLA.

Mr. HUTCHINSON. Mr. Chairman and gentlemen of the committee: I have been asked to represent, not only my city, but the Florida League of Municipalities, in this matter.

I represent, as stated, the city of Jacksonville. Judge Gibbs has spoken for our State, and I also heard the other attorneys general say

they thought they could get by, and actually break even, if the legislation proposed was passed, but they have serious doubt about the effect that it will have upon the cities.

I just want to talk to you about the economic features, for I have not had time to go into the law. I cannot add anything to the legal phase of the situation, except I do heartily subscribe to the full statement of Mr. Epstein submitted this morning, answering your questions as to the meaning of the amendment itself.

I think the explanation on page 339 of the brief is certainly clear enough and adequate for me. I will admit, when I first got interested in this, I was a little puzzled with this matter, myself. But, after making this investigation, I came to the conclusion that it could not mean anything else except what Mr. Seligman said it meant.

So, we say unequivocally that, considering all of the authorities, and the adverse opinion of the Department of Justice, that the Congress does not have the legal power to pass any legislation along the lines proposed.

Now, with reference to the economic aspect of it. We are right now in the middle of a refunding program and all of the cities in Florida find it necessary to refund bonds on account of the economic conditions. Judge Gibbs spoke about those conditions. I realize with our small State we do not cut very much of a figure in our bonded indebtedness. It is only $468,000,000, but a dollar means as much to us as to anybody else, and if the legislation proposed is passed, we cannot refund any bonds.

The CHAIRMAN. You mean you will be charged a higher rate?

Mr. HUTCHINSON. Yes, sir.

The CHAIRMAN. Roughly, what percent of the $450,000,000 of bonds are in default?

Mr. HUTCHINSON. I do not know how much is in default, but, I am sorry to say, a large percent, especially in the south part of the State.

The CHAIRMAN. Would you say one-half?

Mr. HUTCHINSON. Over one-half, in the southern part of the State; but, in the northern part, Jacksonville, my city, is on the preferred bond list, and not in default.

But, as to the other cities in the league, there is a bad state of affairs, and as far as we can economically do so, we have got to be allowed to go ahead with our refunding program, or I do not know what is going to happen.

Even with a rise of only six-tenths of 1 percent increase on 4 percent, the increase we will have to pay in interest is simply scandalous. As a matter of fact I am satisfied that in Florida, for the reasons that we have down there, to personally state that the rise is going to be considerably more than six-tenths of 1 percent. I do not see how anybody would ever have a figure of that kind if they had Florida in mind.

Now, there is just one thing more I want to say, if the Committee please, and that is that even if Congress had the power to pass legislation and the reciprocal feature were included in it, reciprocity would not be anything to us, and I do not think it would mean much to any other State, for the simple reason that the States are not organized.

They have not got the machinery to enforce reciprocity. We cannot go out and trace a man all over the country and bring him back and make him pay taxes.

Florida has a constitutional inhibition against income tax, and it may be one of two States to do so, I say to you gentlemen that reciprocity in Florida would not mean anything to us.

I want to put my league on record as being much opposed to any legislation by Congress on the ground that Congress has no power to pass any such legislation, and, in the next place, to say to you, as Judge Gibbs did, that, of course, if any constitutional amendment is proposed and Florida accepts it, that it will be glad to pay the tax, but it is the present reaction in Florida at this time, as evidenced by two resolutions passed in the Florida League of Municipalities, the other day, and one by the city of Jacksonville, that if such amendment is proposed that it absolutely prohibit any State, county, or city revenues whatever.

Further, the financial, loss which I mentioned, by the tax, be compensated for by making adequate provision for the local taxation of Federal properties in municipalities, to take care of Federally collected income taxes.

For the present, I content myself by imploring you gentlemen to oppose any legislation whatsoever along this line.

The CHAIRMAN. I thank you.

STATEMENT OF JULIAN W. BARNARD, BOROUGH SOLICITOR, NORRISTOWN, PA.

Mr. BARNARD. Mr. Chairman and gentlemen of the committee: I am the borough solicitor of Norristown, which is a borough, not a city. In addition to that, I am a member of the executive committee of the Pennsylvania State Association of Boroughs, and I have been designated by the State Association of Boroughs to represent the small towns of Pennsylvania throughout the State, there being 925 boroughs in the State, in whom reside 40 percent of the population.

It has not been my intention to devote any time to the legal aspects, except for these several questions that have been asked during the argument, and I want to be permitted to comment briefly upon the interpretation of the sixteenth amendment.

It seems to me that it is well settled law that whatever statutory matter comes before the Court for interpretation, that the debates or the statements of the legislators who enacted that statute are taken into consideration as bearing upon the legislative enactment, and, therefore, I think the statements of the Senators who interpreted the intent of Congress in submitting that amendment to the States should be taken into consideration.

In addition to that, I would like to direct to the attention of this committee that we have had that amendment in effect for nearly 30 years, and during that time the Government of the United States and the people have placed a uniform interpretation upon it, their interpretation being that it did not grant any power to tax the instrumentalities of the Government, or the local communities and States.

I submit to this committee that it is a matter of well recognized law that the courts follow where they are interpreting language in doubt, language in a contract and language in a statute, where the inter-

pretations of the parties to that contract have placed upon that language, that is enlightening, and should be borne in consideration, and it should be borne in consideration the fact that the United States Government and the people have not interpreted this for so long a time.

Now, let me go into what we are more concerned with in the small towns of Pennsylvania, so that this committee may have some understanding of what this might mean to the small towns, not for any moment considering that such an act will be passed or will be constitutional.

But, for the moment, let us state what it will do, and what it will mean to the small towns. The small borough of Norristown is typical. There are 40,000 people in Norristown, and approximately 10,000 more nearby.

I venture to say from my personal knowledge that there is not a home in the town of Norristown worth $50,000. The average value of homes is from $750 to $4,000.

It is an industrial community, and the homes are owned by the workers as small home owners. The only source of revenue of the Borough of Norristown and the boroughs in Pennsylvania is the direct real-estate taxation, which has been reserved as a source of revenue to the local communities. Our source of revenue is limited to 15 mills on the appraised valuation of real estate. Our tax rate has been 15 mills for a good many years, and we are compelled by law to render certain very necessary governmental functions, police and fire protection, maintenance of streets and highways, and sanitation and health, and the borough officials are subject to imprisonment if they fail to render those necessary governmental functions. They have to render those functions out of the 15 mills of taxation on the small home owners.

Now, in Norristown, we have outstanding approximately $1,000,000 in funded debt, which means to us in the debt level, that service, just exactly one-third of our villages. It might well be argued that the proposed tax is not a tax upon municipalities, but on the obligations, and, therefore, it is not a tax upon government.

Let me say to you, gentlemen, that the burden will fall on the municipalities, for several years we have had in force in Pennsylvania a personal property tax, and in 1935 it was placed at 8 mills. The boroughs, being creatures of the States, are subject to the will of the State, and that personal property tax fell on borough obligations as well as any other obligations.

Now, it meant just this, when we would attempt to sell taxable bonds, the purchaser, in bidding for those bonds, discounted in their interest rate the tax, and we found very definitely that we can save money by paying that tax on the part of the borough.

In other words, where we issued a tax-free bond, there is no question by the purchaser as to how much interest rate he will have to part with, and, consequently, we saved money.

The last issue of bonds we sold, we sold at 1¾ percent interest. And we have just floated a $100,000 loan at ¾ of 1 percent interest.

Now, if this proposal goes through, it just means putting that burden on the home owner, and the only way the borough can possibly raise any money is to get it from some other source. We cannot raise additional taxes if we want to, and we would have to curtail the police service or the fire service or some other necessary service.

Gentlemen, in conclusion, let me say that, as to whether or not the borough of Norristown should send me here was debated before the borough council, the question of whether it would do any good, or whether it was futile.

But, it was suggested that it was a matter of such desperation to us that the borough voted to send me here, if only to tell your committee that they are afraid of it, and that they are against it.

The CHAIRMAN. Thank you.

COMMENTS BY THOMAS F. CHROSTWAITE, PRESIDENT, THE PENNSYLVANIA STATE ASSOCIATION OF BOROUGHS, SUBMITTED TO JULIAN W. BARNARD, ESQUIRE, BOROUGH SOLICITOR OF THE BOROUGH OF NORRISTOWN, FOR SUBMISSION BY HIM TO THE SPECIAL SENATE COMMITTEE ON INTERGOVERNMENTAL TAXATION

In Pennsylvania we have the 4-mill State tax on municipal debts, a large part of which is incurred in the performance of State mandates (sewage disposal for example). Part of this State revenue is consumed in the procedure—the borough treasurer gets 5 percent for paying it; the tax collector gets up to 5 percent for collecting it; 2 percent is paid for going through the treasury, plus the additional costs in investigations at Harrisburg. The same practice would develop with Federal tax; the local community would have to pay for collecting it and transmitting it, and the debt itself would be incurred in performance of a governmental function, in which perhaps, the Federal and State Government joined. In other words, the dollar is reduced to about 80 cents before it is applied.

Government is not divided into legislative, executive, and judicial branches as distinctly and as importantly as the division in the national, State, and local governments. Note Judge Maxine's discussion in *Commonwealth ex rel. Smillie v. Nicholwes et al.* (327 Pa. 148). Of the three levels of government the local is closest to the people. When you tax local government you are taxing the home owner. In a growing number of States they are exempting the home owner from local taxes by constitutional amendment. Here the Federal Government would be imposing a tax on home owners, for all others could shift the burden.

Any State or Federal taxes are particularly vicious at this time. A State tax of 4 mills (to which the Pennsylvania State tax on personal property has now been reduced as to municipalities) formerly was 10 percent of the interest rate. Now, it is approximately 25 percent due to reduction of interest rate. The low interest rate has encouraged in Pennsylvania the construction in large numbers of boroughs the local water plants, and also the construction of sewage-disposal works under the State's requirements. It is the low interest rate which permits this A bond issue of $100,000 on a 2-percent basis would produce from $125,000 to $150,000 if taxes were added to the interest rate allowed. The very thought of Federal taxes will deter municipalities from some of these undertakings. I have personally been identified with three municipal water-plant projects during the past year. They would never have been started were it not for the low interest rates and labor paid by the Federal Government.

Municipal employees differ in many respects from other employees. In the first place they are not within the range of any social security acts. Many times they are kept on the pay roll purely out of charity and because of long service. They are never overpaid, and employers are not operating for profit—thus any tax placed upon employers cannot be passed on to consumer. Furthermore, the municipality as an employer must continue in business, must furnish continual employment. This applies to both municipalities and school districts.

There is another element that is entering into this picture. The freedom from taxes by federally owned real estate, housing projects, etc. (thus reducing the taxable property within the municipalities).

I note in the report the late case to the effect that damages for defective sidewalks cannot be collected against H. O. L. C. property.

STATEMENT OF JULIUS HENRY COHEN, CHAIRMAN, LAW AND LEGISLATION COMMITTEE, AMERICAN ASSOCIATION OF PORT AUTHORITIES

The CHAIRMAN. Mr. Cohen, we will now hear from you, which will be the final argument tonight.

Mr. COHEN. Mr. Chairman and gentlemen of the committee: There are a lot of lawyers who have appeared before you, and we cannot help but thank you and show our appreciation for the manner in which these proceedings have been conducted.

In coming before you I feel as though I were coming before a court and arguing my case before judges who have knowledge of the law, and have briefs before them, and have serious doubts in their minds, and I want to say that we have received not only a courteous but a very patient and careful consideration. We want to return this courtesy accorded us by being helpful to you.

The task was assigned to me throughout this hearing of listening to the questions asked from the bench, if you will pardon that expression, from every member of the committee, and to answer those questions the best I can if I could be of any help. I had hoped I could do that, after preparation tonight, and I hope, before I leave the stand, to give you an answer to all the questions that have come from the bench.

First of all, it goes fundamentally to the point of what your duties are, and to discuss what the effect will be if you recommend the passage of this legislation.

Let me assume, for the purpose of this argument, that you will have had the benefit of briefs and of oral presentation and that there still remains a doubt as to the meaning of the sixteenth amendment.

What, then, is your duty? It so happens that that very question was discussed at great length in the House debate and I suggest that you read that discussion and read what some of the lawyers there had to say.

As I sat in the gallery listening to the debate I should have liked to go on the floor and participate in that discussion, for no one seemed to realize adequately what the Government was asking to be done here, and although it is very clear, it has not been referred to as yet.

I ask you to turn to the White Book at page 84, reading:

> The value of an affirmative direction by Congress, of course, lies in the fact that the tax would be supported by the full weight of the presumption of constitutionality which attaches to an act of Congress. The ordinary case relating to tax immunity has no such support; it arises merely because the tax officials have applied a general statute to one claiming immunity. Here, the decision would be made in the light of a judgment by the Congress that the tax in question was probably not forbidden by the implications of the Constitution. This deliberate judgment of the Congress could not but influence the decision of the Court.

So, you certify, when you recommend this, that you, as lawyers, are satisfied that this is the proper interpretation of the Constitution, and you are asked by the Department of Justice to give it the sanction of your approval.

You are asked by the lawyers for the Government, in the White Book, as lawyers, to put your stamp of approval on the law, so that they may go then to the United States Supreme Court and say that Congress has passed upon the question of constitutionality and that

able lawyers in the Senate have placed their stamp of approval on what the White Book declares to be the law.

Now, if you are in doubt as to the law, you certainly cannot in this proceeding, as lawyers, do that. That is elementary law.

Every lawyer here has heard a charge to the jury on the question of reasonable doubt, and knows that the jury must give the benefit to the defendant of reasonable doubt, and if you leave the situation in doubt and certify that you have no doubt, you violate your oath of office as Senators, if you do that.

Now, we did not come here today with any expectation that your own legal adviser, independently, had examined the conclusions arrived at by the Department of Justice, and that he, as well as ourselves, disagrees with every one of them. He came to that conclusion after careful examination, to an independent conclusion, as you will find in this careful study of the law, which, obviously, can now be discussed to the same extent as it would be in the United States Supreme Court.

Senator MILLER. Referring to the statement as to the duties of Congress, or the duties to pass upon the constitutionality of the proposition in the first instance, I was somewhat amazed after reading the proceedings in Congress yesterday.

While I used to be a Member of the House and I have a great deal of respect for the House and regard it as one of the greatest bodies in the world, if I read this interesting statement, as one of the jurisdictions, I do say, if we pitch our argument on the ground of nondiscrimination, which is, I think, the heart of the jurisdiction, if it be sustained, then that is a stronger approach, and a more convincing approach, that all discrimination be eliminated by giving to the States the right to tax this kind of income from Federal sources, if back of it is the idea of discrimination.

What are you saying if Congress would act negatively? It would reinforce your judgment. I do not think there is any doubt about that. In other words, the record shows they want to test the problem with no discrimination as the material theme.

Mr. COHEN. If you will read that brief a little further, you will also find that one of the Representatives said that he was going to vote for this proposition with his tongue in his cheek, for he did not see how the Supreme Court was going to hold it otherwise than as unconstitutional and, moreover, Congressman Reed quoted from questions and answers of Mr. Morris before the Ways and Means Committee. I shall not take time to read it, in order to avoid a too extensive argument, but I ask you to make a note of page 42 of the hearings before the Ways and Means Committee of the House, of January 26, 1939, in which Mr. Reed, of the Ways and Means Committee, put Mr. Morris on the rack, and he knew it. He said:

> Do you tell us you are clear this thing is constitutional?

And Mr. Morris, being a gentleman and an honest man, said:

> I would not be true to my conscience if I said it was entirely clear.

So, on the floor of Congress, yesterday, Mr. Reed made the point that the House and the Senate were being asked to certify to the United States Supreme Court this construction of the Constitution, when the officer, in charge of the debate for the Department of Justice, himself, after all of this study, was in doubt.

The whole argument before the House yesterday was, literally, "Put it up to the Supreme Court."

If a litigant wants a declaratory judgment from the United States Supreme Court, he does not go to Congress, for an act, but he brings a declaratory suit and then lets the Supreme Court pass upon the question.

But to go to the Congress and say that you are going to put the pressure of the Congress upon the Supreme Court to change what they now consider is the law, I think, is not proper.

In this same discussion before the Ways and Means Committee, Mr. Morris conceded that *Collector* v. *Day* had not been overruled, and that the *Pollock case* (*Pollock* v. *Farmers Loan & Trust Co.*) was still the law.

Senator MILLER. Someone just took the position that that was the trend.

Mr. COHEN. If you will read our brief, you will see there is not a leg left to stand upon. You will find that there is no such "trend," and I challenge any lawyer to read these two briefs and come to the conclusion that the United States Supreme Court has overturned precedents of 120 years on the proposition of the reciprocal relationship of the States and the Government.

I want to elaborate on that a little bit more.

In the Gerhardt case we submitted the proposition that, if we showed that the Port Authority was essentially a governmental function, we did not care a fig about whether Mr. Gerhardt was performing a governmental function in the capacity of an engineer or in the capacity of accountant or clerk.

We never got a chance to prove what his duties were as an official of the State, but the Court said—let me interrupt my argument long enough to say this—that the basis of the Government's argument first was that we existed under a compact between New York and New Jersey, under the consent of Congress, and that subjected us to the Federal courts; that we were engaged in the field of interstate commerce, and, therefore, this gave Congress the power to tax, and that we were engaged in the performance of a business function.

This issue now before you was not discussed by the Court. All the Court said was that Wilson and Gerhardt and Mulcahey were not shown to be performing duties any different than they would perform in a private business.

So, when we came back, with blood streaming down our faces and our uniforms all torn, we sat down like good lawyers and took the opinion and then we found that the Court had reaffirmed the immunity of our bonds, and it was then we gave our opinion that our bonds were immune.

If our bonds are selling at the same rate today, it is based on two conclusions; first, the opinion of the Supreme Court, and the opinion of the Attorney General of New York, and the opinions expressed by the 39 attorneys general, and, coupled with the Hughes opinion there was a natural feeling on the part of investors that there was nothing to this—that it was just a debate, and that when it got to Congress it would not be passed, in the first instance, and, second, that if it did the United States Supreme Court was not going to sustain this claim.

Now, let me tell you this astonishing thing: Only within the past month we have sold 16 or 17 million dollars of our bonds to life-insurance companies and savings banks, because their lawyers know perfectly well that the position of our bonds as tax-immune is not going to be changed by the United States Supreme Court.

When you come to a review of the cases, you will find this to be the fact, that whatever the rule may have been regarding salaries, that is not the same rule regarding bonds.

You asked Mr. Epstein this question about salaries, and that is a cue to take them up in my notes.

The CHAIRMAN. I want to get this one thing clear for a moment. I have heard something today about analogues, and I want to know is this, is analogue analogous to analogy?

Mr. COHEN. We have a lawyer on the bench was a dean of the law school at Columbia, and he uses such words as that. If I had to do it, I would probably have said, "It has its analogy." In other words, you get what is clearly meant.

The CHAIRMAN. In other words, they are the same.

Mr. COHEN. He said the duties are just the same as if performed in a private capacity.

The CHAIRMAN. Going back to the Senate's duty in the premises, I would like to discuss a little what Assistant Attorney General Morris said on page 11 of his letter of transmittal.

He said:

> Only by such legislation can these questions be settled.

That is, the question of their constitutionality, by which he meant the questionable or doubtful constitutionality can be settled in no other way, and that is as to the power of Congress to enact a piece of legislation, except by enacting it and presenting it to the Supreme Court.

He says further:

> The enactment of legislation under substantially similar circumstances was approved by the Supreme Court in *Evans* v. *Gore*. There, in discussing the propriety of its consideration and determination of a question which affected the salary of judicial officers, the Court noted the expressions of Members of the Congress who, notwithstanding strong doubts as to its constitutionality, had supported the legislation in order to secure a determination of such constitutional questions which could not otherwise be settled. That the Court sanctioned such a course cannot be doubted.

It seems to me that is a fairly reasonable proposition, that if I am in doubt as to the constitutionality of this measure, and if I cannot come to the conclusion that socially or economically speaking there is a situation of unjust taxation, that this situation of unjust taxation should be remedied, would I not be justified in saying, as was said by the Member of the Senate who favored the legislation involved in *Evans* v. *Gore:*

> I have doubts about the constitutionality of this measure, but I think that the constitutionality should be determined, and, therefore, with those doubts in mind, I vote for the passage of this legislation, and present to the highest authority the question of its constitutionality.

I think that that is the position of the Government lawyers in this matter.

Mr. COHEN. Yes; but the Government itself tells you, "We do not want you to submit the question alone as one of doubt, but want you

to put your construction on it, so that they may have the presumption of constitutionality in arguing the case," and that is said in the portion that I quoted.

But, certainly, if this legislation does pass, there will be many expressions on the floor of the Senate as to the doubt of the constitutionality of the measure.

Now, I think, when we consider *Evans* v. *Gore*, Congress was putting up to the Supreme Court legislation it never passed upon. But here you are asking the Supreme Court to reverse itself, and upon that you negative any doubt. I find in *Evans* v. *Gore* the following:

> Does the sixteenth amendment authorize and support this tax and the attendant diminution; that is to say, does it bring within the taxing power subjects heretofore excepted? The court below answered in the negative; and counsel for the Government say: *"It is not, in view of recent decisions, contended that this amendment rendered anything taxable as income that was not so taxable before." We might rest the matter here but it seems better that our view and the reasons therefor be stated in this opinion, even if there be some repetition of what recently has been said in other cases.* [Italics supplied.]

The whole argument has been that everybody has been mistaken. Mr. Stam has been mistaken, the lawyers for the Internal Revenue Department have been mistaken, the United States Supreme Court and everybody else has been mistaken as to the constitutionality of the sixteenth amendment, and now somebody has discovered a new construction to it, and, if you go to the Supreme Court, they will say that is your construction.

We want to convince you that there is no basis whatever for expecting such a changed attitude on the part of the Supreme Court, and we say to you, with all the earnestness that we can, that you cannot have any doubt when you get through studying this question.

You say that your namesake wobbled, but you cannot say that Senator Borah or Senator Root wobbled, but, if the country relied upon them and relied upon what they said, and it has done so for all of these years, and we have relied upon it, is there any better construction than that of what the intention of the people is?

The CHAIRMAN. Mr. Cohen, I think, on that proposition, that the people of the United States relied upon what the amendment said, and not on what Senator Borah or Senator Root said.

Mr. COHEN. No, sir; I want to call your attention to one thing, one factor. There is a complete answer on page 27 of this report (by counsel for the committee). There is a very excellent article, which I suggest that you read in full, written in 1934 by Mr. William Anderson, to whom Mr. Stam refers. This is what Mr. Anderson says and which Mr. Stam adopts, and which we adopt:

> Can it be assumed that Congress, without discussion of the question by the clumsy use of four words in the middle of an amendment, intend to introduce a change of so tremendous significance? New and fundamental powers are not usually conferred by a single phrase found in a provision having a different purpose. If the broad construction would be applied to the amendment, it might be even broad enough to tax the incomes or revenues of the State or municipal governments themselves. Furthermore, this broad construction, if taken literally, would authorize the impairment of the obligations of contract.

That is perfectly obvious, and it is true that the Government is attempting to do that in our own port authority case. They are attempting to tax our revenues as well as our securities.

The sixteenth amendment says, "from whatever source derived," and they say that includes the revenues of the States and the cities

themselves, and, when you go that far and endeavor to get that construction, may I ask, did the people of the United States decide anything like that?

Senator MILLER. In that connection, I doubt whether that question can be answered in view of the record.

I was interested in looking at the brief where you gentlemen have given us the benefit of the record. But only seven governors, in submitting the sixteenth amendment, as proposed, to their legislatures, really expressed an opinion on it, as I understand. They were rather unequivocal in their statements as to this question that had been raised by Governor Hughes and answered by Senators Borah and Brown.

I am wondering, really, if you have any way of knowing, or have gone through these messages—all told, 52 messages—referred to in the brief, and which were submitted to the legislatures of the various States.

It is rather strange to me that only seven of the Governors did actually call to the attention of the legislatures, that is, specifically called the attention of the legislatures to this one question.

Mr. COHEN. Senator, we are sitting around a room, and about nine lawyers have drawn a legal document, and one of us says, "I think that paragraph might be construed to mean so-and-so," and all of the rest say, "No, it cannot mean anything of the sort," if that interpretation would mean a conveyance of title to property which the parties never intended to convey, using that analog, of a conveyance as a grant of power, the rest of us saying, "No," and only one lawyer saying, "I have a little doubt," and the other lawyers saying, "It is clear"; what would be the conclusion?

But here you are not dealing with an ordinary contract that has to be interpreted according to the literal language.

If the people of the United States had understood that they were, by such a construction of the grant of power, changing or overturning the Federal system that had been maintained throughout the years, sustained by every decision of the United States Supreme Court, if they had understood that the States were not to be supreme in their field as the Central Government, is in its field and this was no longer to be an indestructible union of indestructible States, the amendment would not have been adopted, and you are now asked to say that the people, because it was not discussed, ratified the things that are now sought to be done.

Remember that this constitutional amendment was presented to the people of the United States, with these other opinions. The opinions of Mr. Root and others were considered and reiterated and confirmed by a series of decisions of the courts of the land, namely, that we are an indestructible union of indestructible States——

Senator MILLER. The proponents will have to admit that at the time the sixteenth amendment was submitted, as far as I know, there was not any dispute or any question of the fact that as to whether or not the Federal Government did not have the right to tax without apportionment.

Mr. COHEN. They had the power to tax income.

Senator MILLER. I know that, but even under the *Pollock case*, the Court was agreed upon this further proposition that they did not have the right to tax income from State securities.

Now, I asked the question this morning, if, since the Pollock decision, you can put your hand on anything that is convincing, that actually shows where the Court is departing from that one principle.

Mr. COHEN. The cases that have been decided since the sixteenth amendment in which municipal and State bonds have been held to be immune, and the Pollock decision is still the law of the land.

If the sixteenth amendment changed it, what right had Governor Hughes, then a practicing lawyer, to advise the public that port authority bonds were immune. He had been on the Supreme Bench of the United States, and the sixteenth amendment was held not subject to the construction now urged. How could he then advise the investing public that the bonds were not immune from taxation; how could he avoid holding in cases since then that municipal bonds and State securities are not subject to taxation or how could he possibly advise that the sixteenth amendment had changed the rule as it stood before?

Senator AUSTIN. Would it not be a very strange circumstance that the sixteenth amendment did not appear in those cases if it had any bearing on them?

Mr. COHEN. Yes. That brings me to the question asked this morning. The lawyer did not answer it with the same knowledge of the case that we have. Mr. Epstein is responsible for calling my attention to it.

At the time you asked the question, you asked if the question came up about the sixteenth amendment, and the answer was no.

It did come up in the *Gerhardt case* by the concurring opinion of Mr. Justice Black. He invited his colleagues to reexamine the rule. Not one of his colleagues accepted his invitation.

Now, up to that time, nobody had questioned it at all.

So, when you have the record of the interpretations concurrently of distinguished lawyers in the Senate, when you have the contributions of record of the United States Supreme Court in its decisions, and when you have the whole country relying upon it, are you going back and take the literal language or words separate from the context of the instrument, separate from the concept of the Federal Government itself, and say that *Evans* v. *Gore* was wrongly decided, and that the *Brushaber case* was wrongly decided, and that the judges did not know the history of their country?

This is not the situation where you have some doubt about some social legislation; you are passive and want to put it up to the Supreme Court.

Here you are asked to say that the American people deliberately, with full knowledge, changed the form of our government and that the Supreme Court has been consistently in error.

Senator AUSTIN. Let me ask you, before you leave that, calling attention to page 29 of Mr. Stam's report, where he says:

> If the only income tax authorized by the sixteenth amendment is a tax on income without regard to the source from whence derived, all of our income-tax laws, beginning with the Revenue Act of 1913, would be unconstitutional.

Mr. COHEN. I intended to suggest that the Congress has continuously asserted that construction of the Constitution, that it has acted upon the advice of its own counsel and legal advisers, not only Mr. Stam, but Mr. Gregg, and the Under Secretary of the Treasury, and they have all said that the only way to approach this was by constitutional amendment. Yet, you are asked, gentlemen, to throw

overboard the opinions of those who have made a study of this problem, throw overboard the entire history of the construction, and to say that, while you have some doubt about it, yet you want the Supreme Court of the United States to pass upon it, and certainly in such a case I do not believe that any Senator would do that, and I want to say that there is no Senator, in my judgment, that can, in the light of this history, say there is a reasonable doubt which would lead the Judges of the Court to say that they had been in error.

You are not asking for a decision on a new question. You are asking the Court to reverse their decision in *Evans* v. *Gore*. You, the Senators of the United States, and the House of Representatives, are saying to the Supreme Court, "You are all wrong."

Senator Miller, you know what motions for reargument or for new trial or for newly discovered evidence are like.

Senator MILLER. I have had that experience.

Mr. COHEN. You ask for some substantial evidence.

Now, read the White Book and see what newly discovered evidence they have, and would you recommend a new trial on this? A letter from a Senator to a friend 10 years after the event.

Senator AUSTIN. Do you not recognize that Congress has passed upon this and has acted upon this in passing the tax laws?

Mr. COHEN. Yes, sir; and that is made clear also in Mr. Stam's report, and also made clear in the report of the joint counsel of the Finance and Ways and Means Committees, and also made clear in the report of the Ways and Means Committee in 1922 or 1923.

Mr. Gregg wrote a very convincing opinion in which he referred to *Evans* v. *Gore*, and discussed the sixteenth amendment, and advised the Ways and Means Committee, and the Ways and Means Committee made a report, and they said that the only way to do this was by constitutional amendment.

Can there by any clearer interpretation by the Congress?

Now, may I proceed to the next point?

The CHAIRMAN. Yes.

Mr. COHEN. I just want to make it clear to the committee about this matter of salaries. A strong case can be made on the subject of salaries.

You have asked this young man from Pennsylvania to send you a report as to the amount paid salaried employees, and I suggest that you get the result of the report on Federal employment, and you will find a full report on comparison of the pay of public employees as compared with private employees.

We have deliberately refrained from discussing that phase of the question, for we are, ourselves, public employees, and it is not in good taste for us to discuss it. Our argument embraces a more fundamental question.

But, let me say this, that we point out in our brief that in a current decision, the *Stillwell case*, it was held that the construction the Government is urging upon you is not sound when they say that *Collector* v. *Day* has been overruled. The *Stillwell case* is authority for the proposition that it has not been overruled. Furthermore, in the *Wrightington case* before the Board of Tax Appeals it was held that the *Gerhardt case* does not reverse *Collector* v. *Day*.

The CHAIRMAN. What were the facts in the *Stillwell case* and the *Wrightington case;* by what agency were they employed?

Mr. COHEN. Wrightington was employed as a lawyer for a town in New Jersey, and the Board held that, as a lawyer for a town or city, he is engaged in a governmental function.

The CHAIRMAN. And the Government has appealed?

Mr. COHEN. Yes.

Senator AUSTIN. I should think that might be complicated by the question as to whether the employment was for a long time or just for a short time, or all the time.

Mr. COHEN. The Board held he was employed all of the time.

The CHAIRMAN. What were the facts in the *Stillwell case*?

Mr. COHEN. Stillwell was a master in chancery in Chicago, a court officer, but he received his compensation out of fees from litigants.

The CHAIRMAN. That is hardly clear-cut.

Mr. COHEN. But it is helpful, for in the *McLaughlin case* it was held that where you get your fees from somebody else, it does not make any difference.

Nevertheless, the Government made the argument that the *Helvering* v. *Gerhardt case* had reversed *Collector* v. *Day* and all previous opinions. The circuit court of appeals said, in effect:

> We have read *Helvering* v. *Gerhardt* several times, and since the Supreme Court referred to *Collector* v. *Day* several times in its decision; as we read the opinion, it actually reaffirmed *Collector* v. *Day*.

The CHAIRMAN. Distinguishing the facts?

Mr. COHEN. Distinguishing the facts.

We say in our brief that as to the salary question you do not have to act upon that, because if the Government wins in the *Stillwell case* and the *Wrightington case*, the States will have the right to tax and the Federal Government will have the right to tax the salaries.

The thing is before the courts now, and there is no more to be argued on that in view of the two appeals which will give the Supreme Court the opportunity to pass upon that question.

Another decision on review is by the Court of Appeals of New York, holding that counsel of the Home Owners Loan Corporation is not subject to Federal taxation.

The State of New York is appealing, and Mr. Epstein is arguing in the Supreme Court that "what is sauce for the goose is sauce for the gander"; that since they had held that the Government could tax our port authority employees, therefore, the State of New York can tax the Home Owners Loan Corporation employees; and that what the Supreme Court said in the *Helvering* v. *Gerhardt case* it will have to say in this other case; that the rule works reciprocally.

And if that is established, you will have that principle established, and you will not have to have any legislation.

The CHAIRMAN. Is there any governmental function involved?

Mr. COHEN. Now, just a moment; the Court went further in the *Gerhardt case* than it had ever gone before, as to employees, and it said that even if the institution is performing a governmental function, the individual who is doing the work is not performing a function which is essentially in the service of the Government.

As they said, if the services have an analogue in a private field, there is no immunity, and so the Supreme Court said that if you do not show it is a burden, or if the burden is speculative and conjectural, then it is not an interference with State sovereignty, as was said in the dissenting opinion by Mr. Justice Roberts in the *Brush*

case. It is well settled that where the tax on the salary of a public employee was a speculative and conjectural burden on the State there is no interference with State sovereignty.

That question was not argued in the *Gerhardt case*, and we were not permitted to argue it, but the day will come when it will be argued.

The CHAIRMAN. You do feel that the constructions with respect to taxation on State securities by the Federal Government is on a somewhat different basis than the question of the right to tax the salaries of State officials?

Mr. COHEN. When we say "somewhat," we are going into a wide field. By that, I mean that it is possible for the Supreme Court of the United States to hold that the salaries are taxable, and that the securities are not taxable. I agree with you that the Supreme Court can hold that certain salaries come, under the sixteenth amendment, "from whatever source derived," but I also agree with Mr. Stam that you have got the same constitutional principle involved in the case of some salaries as in the case of bonds.

Senator AUSTIN. Mr. Stam carries the theory to the extremity that salaries of school teachers, State hospital employees, and other employees performing functions which are not indispensable to the existence of the State are subject to the Federal tax.

Mr. COHEN. For the purpose of this argument we will assume that school teachers are not essential to the life of the community, or that a doctor is not essential to the life of the community.

The CHAIRMAN. That is not the test. It is the distinctive question of an essential governmental function.

Mr. COHEN. The important question here is whether it would interfere with those functions of government essential to the life of the State, and that is the fundamental distinction between salaries and bonds. You can argue on both sides. You can argue till the cows come home on both sides of the question, as to salaries, but you cannot argue it as to bonds, for the United States Supreme Court has said that the taxing of securities of the States or of the municipalities is beyond the power of the Federal Government. Such a tax is clearly a burden on government.

Senator MILLER. See if I understand your position. It is this: That the question herein involving salaries is in such a condition now, in litigation and in pending cases, that it can be determined from the cases now pending; that is, the right of the Congress and the right of the States can be determined by virtue of the Supreme Court decisions, and that the right of Congress to tax bonds has been determined already—determined that the Congress does not have the right to tax them.

Mr. COHEN. Yes, sir; exactly.

Now, I want to turn to one matter. You were asking Mr. Ferguson certain questions when he was on the stand, and I should like more completely to answer the questions; and, to do so, I am going to get away from the port authority for a few moments.

Senator MILLER. You have reference to that question that I asked about the statement he made that he could not have issued the bonds and sold them?

Mr. COHEN. Yes; that we could not have built the bridge.

Senator MILLER. I think that that was just a slip of the tongue.

Mr. COHEN. No, sir; it was not; and before I am through, I will convince you that he was right about it.

You will remember, Mr. Moses, of the Triborough Bridge Authority, gave you the same opinion, and Mr. Costello, for the Delaware Bridge Co., gave you the same testimony.

These men are experts. These men do not come here with statements made on the spur of the moment, and I want to prove to you this matter in the most comprehensive way that I can. It will take but a few moments, and it is very important.

In 1931 Governor Roosevelt asked me to serve as a member of the St. Lawrence Power Commission, which was to consider the problem of development of power in the St. Lawrence River, and I was made vice chairman and counsel for that commission.

There served on that commission Mr. Robert Murray Haig, an eminent economist, Mr. McVickar, a professor at Columbia University, who had been a tax expert for years for the State of New York, and then Mr. Frederick M. Davenport, Mr. Thomas F. Conway, and Mr. Samuel L. Fuller, banker, and myself, as vice chairman and general counsel.

The task that we had was, How can we develop the power of the St. Lawrence River as to get cheaper power for the farmers and other people of the State? We had to consider how that could be achieved, and I hold in my hand the report of that committee. There are only 2 or 3 paragraphs which I shall submit to you. You will observe from the mere inspection of it that it was an exhaustive study. There are masses of statistics and figures here, because it was contemplated that the State of New York would not spend a dollar of its own money, to be raised by the general revenues, on the development of the St. Lawrence power. It could not and did not have the money. So the question was, How could you do this the way the port authority had built its tunnels and bridges? I was then general counsel for the port authority and the general counsel for the commission before the port authority was created. Upon my report as the general counsel, the port authority was created, and the whole scheme on which it was built up was the report made to the State and adopted in the compact. I had also been asked by Governor Smith to advise upon the housing problem along the same lines.

Now, as to housing. When they came to me they said: "We have got to do something. The State has not got the money. We have got to get the money. And we have got to have low-cost housing.

"We find that the cost of rooms per month in the tenement-house districts and every other district depends very largely upon the interest cost upon the money you have to borrow, first and second mortgages, and we tell you, Mr. Cohen, that for every 1 percent in interest that you cut down, by any scheme that you work out, we can cut down the rentals we have to collect $1 per month per room."

What did we do then? We tried to see how low we could borrow money. I do not happen to have here the recommendation for the housing report, but I do have in the St. Lawrence report the advice to use the "tax-exempt bond," because the tax-exempt bond everybody understood would be a low cost.

Whether you are constructing low-cost housing or productive power, or, like the port authority, building bridges or tunnels when you come to estimate the cost of your enterprise, you have got to keep down the

interest that you have got to pay, and if the interest charge is such that the revenue will not meet it, the prospective purchasers will not buy the bonds.

So it was literally true that in view of the fact that we were building the first of the great bridges—until the San Francisco Bridge the George Washington Bridge was the longest single span in the world—we could not have sold the bonds if the rate of interest had been higher. The tax-exempt feature was vital.

When we were planning that, the investors looked at the figures. They looked at the estimate of the engineers, and they checked on the estimates of the engineer, and they considered our construction costs, and then at the interest rates on the basis of tax immunity on our bonds, and they said that that was a reasonable proposition. Then they had to consider the prospective traffic, and they guessed wrong and we guessed wrong as to three of our three ventures, but we guessed right as to the George Washington Bridge.

The Holland Tunnel was upon a different basis.

So you can see the interest rate which we pay turns upon whether our bonds are tax-exempt, and that is a vital consideration, and the fact is that we could not have sold the bonds with the bonds taxable, for the tolls would have had to have been much higher to meet those interest charges, and the bankers would not have recommended it, and we could not have sold the bonds.

Senator MILLER. You mean that the tolls would have to have been too high, and that the people would not have used the facilities?

Mr. COHEN. Yes, sir; and that is the fact, as stated by Mr. Ferguson, when you make them taxpaying bonds, we will have to raise our tolls, and then the public will not use our bridge. They will use the ferries.

I want you to understand that we have got competition.

They will use the ferries if they can get a cheaper rate, and, if we are forced to pay taxes on our bonds, they will use the ferries and we will not collect the tolls.

Now, let me point out another thing, and that will bring it home to you in a practical way. We are not talking theory or along the lines of mere blueprints. We have had to sell $250,000,000 of bonds. In the case of the Camden Bridge, you could never have got a bridge across the Delaware except with low-cost financing.

Mr. Moses conceived the scheme of building the Triborough on the same basis as the port authority, and he got authority and also got the money for the Henry Hudson Bridge, on the same basis, so that now you can go from Fifteenth Street and Eighth Avenue to Westchester County in 45 minutes. It used to take me 3 hours to do it, and I pay 10 cents for this privilege. But Mr. Moses had considerable difficulty, even on a 10-cent toll, in financing the project.

Now, Senator Logan is not here, but there is one question he asked that I wanted to answer, and that was this: He asked the question of one of the witnesses, What would happen if the Supreme Court said that the sixteenth amendment meant exactly "from every source"? What would happen if we could not pay our bonds? What would be the situation?

As you know, there is no legal obligation upon the part of the State to come to our rescue. They cannot appropriate moneys for such a purpose now. I just cite that as an example.

Now, I want to turn to the suggestion about refunding bonds, and whether it would be possible to exempt them.

In the first place, you have got the difficulty of defining "refunding bonds." But let me call your attention to this fact: As we go ahead, we are called upon to build other bridges, and we are refunding, but the tax that would affect new bonds would seriously affect us. The Holland Tunnel, was the first tunnel under the earth through which gasoline vehicles were ever driven, where the ventilation problem was vital, was built at a cost of $50,000,000. That $50,000,000 was paid for, one-half by the State of New York and one-half by the State of New Jersey. The State of New Jersey paid for it by a bond issue submitted to the people of New Jersey. New York paid for it out of appropriations.

Then came the depression. The people wanted a tunnel in middle New York, the Lincoln Tunnel. Now, the Holland Tunnel was the best business producer, and when you come to the World's Fair this year, you will go through the Holland Tunnel——

The CHAIRMAN. It is a very good thing we do not have any Californians here when you are advertising the World's Fair in New York.

Mr. COHEN. I would be glad to have any people from California here to go through our tunnels.

Now, here was the State, in the middle of the depression, and it could not possibly appropriate the money for the new tunnel. It did not have it, and it could not raise any more money by bonds. The people would not stand for it.

So, they said to us, "We will turn over the Holland Tunnel to you, which is earning more than the interest on the $50,000,000 that it cost, and you pool all of your enterprises together, and you raise $50,000,000 on your bonds, port authority bonds, and pay back $25,000,000 to each State, and then, on the strength of the revenues you borrow more money and build the new tunnel."

And we did it.

Now, those new bonds we issued were not refunding bonds; they were absolutely new bonds issued by the port authority.

You have got ventures like that all around New York.

The Mayor of New York meant to tell you that new bonds will have to be issued to safeguard the needs of the city. When we issue those bonds the Congress of the United States extended their approval.

I want to tell you something else. There came the depression after we were authorized to build the Lincoln Tunnel, and we were required to go in and get the money. Somebody had to lend that money.

It was during President Hoover's administration, and the question was, what were you going to do about the depression, and it was said that everybody had got to spend, and they said to us, "Do not spend until you know you will get it back."

The port authority was the model of the self-liquidating enterprise, and since it would be furnishing employment, and, at the same time, creating something which would repay the loan that method was approved by Congress.

When we were halted by the depression, we came down here to the R. F. C. and borrowed 37½ million dollars on our bonds, and this money we repaid within a year and a half, and the bonds were taken up. But, before we sold those bonds to the R. F. C., they insisted, not on

my legal opinion, as the general counsel of the port authority, but the opinion of counsel selected by them, that those bonds were immune from taxation, and Mr. Jones took the bonds on that basis, that they were tax-immune, and they were sold all over the country on the opinion of counsel that they were tax-exempt, on the sixteenth amendment as interpreted by the courts. The Reconstruction Finance Corporation took the bonds on the basis that they were immune, and sold some of this kind of bond to the public as tax immune and made a profit on them.

Now, to come back to the point I wanted to make about the St. Lawrence power project, I want to hand you an extract from this report of the St. Lawrence Power Development Commission and have it incorporated in the record.

The CHAIRMAN. It will be received.

(The extract from the report above mentioned is as follows:)

EXTRACTS FROM THE REPORT OF THE ST. LAWRENCE POWER DEVELOPMENT COMMISSION, SUBMITTED JANUARY 15, 1931, TO THE GOVERNOR (HON. FRANKLIN D. ROOSEVELT) AND THE LEGISLATURE PRECEDING THE ADOPTION OF THE LEGISLATION OF 1931 CREATING THE ST. LAWRENCE POWER AUTHORITY, CONSISTING OF ROBERT MURRAY HAIG, CHAIRMAN, JULIUS HENRY COHEN, VICE CHAIRMAN AND COUNSEL, THOMAS F. CONWAY, FREDERICK M. DAVENPORT, AND SAMUEL L. FULLER.

Extract from Chapter V: The Proposed Power Authority.

Subject matter: "Financing the Project Through a Public Power Authority."

Discussing the matter of the value of bonds issued by the Power Authority as a basis for carrying on the enterprise, the Commission unanimously said:

"Since bonds of such a public authority are not readily marketable unless they are made legal investments for savings banks, trust funds and public officers generally, legislative action is required making them available for that purpose. Action by the legislature in this regard is not taken except after most careful study of the project and upon determination by the legislature that there is no substantial financial hazard in the enterprise. Hence in considering the program of legislation dealing with recommendations by your Commissioners, consideration will be given to the economic soundness of the enterprise. It is for this reason that the boards of engineers and marketing experts have gone into such considerable detail in their reports.

"Since the State itself could engage in the enterprise, the property and the securities issued by the Power Authority are State instrumentalities and will be immune from Federal taxation. This means a rate of interest lower than that upon which money can be borrowed through the method of private corporate finance. It means also the early amortization of the entire cost, and thereby the ultimate elimination of interest charges. Through this method, without the use of its own credit, and without burdening the taxpayers, the State ultimately acquires a property out of the revenues derived from its operation" (p. 35).

Extracts from the Report No. 4 on Questions of Law by Counsel and Legal Staff (p. 144):

"A public corporate agency of the State of New York, its property and income, its securities and the income therefrom, and all its other activities, are exempt from taxation by the United States.

"It is one of the fundamental rules of our constitutional system that the United States may not levy taxes upon the property, activities, agencies, and instrumentalities employed by the States for the exercise of their governmental powers. Conversely, similar protection is extended to the United States from taxation by the States. The leading cases which establish these correlative principles are *McCulloch* v. *Maryland*, 4 Wheat. 316 (1819); *Dobbins* v. *Commissioners*, 16 Pet. 435 (1842); *Collector* v. *Day*, 11 Wall. 113 (1870); *U. S.* v. *Baltimore & Ohio Railroad Co.*, 17 Wall. 322 (1872).

"The principle, as stated in the famous phrase of Mr. Chief Justice Marshall in *McCulloch* v. *Maryland*, is this:

"'That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance, in conferring on one government a power to control the constitutional measures

of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied.' (p. 431.)

"In the first of the cases dealing with the right of the State to be exempt from Federal taxation, *Collector* v. *Day*, *supra*, the Court said:

"'The States within the limits of their powers not granted, or, in the language of the 10th Amendment, "reserved," are as independent of the general government as that government within its sphere is independent of the States.'" (p. 124.)

* * * * * * *

"Based on these four leading cases, the rule of mutual exemption from taxation appears to be applicable to any and all of the instrumentalities and agencies which either sovereignty may select or use for the execution of its powers. Every exercise of the sovereign power for its proper and normal ends in whatever form and through whatever agency is wholly free from any burden of taxation levied by the co-sovereignty upon any instrumentality or form of the activity."

Mr. COHEN. The point I want to make is that everyone who signed this report, the lawyers, the economist, banker, former Congressman, certified to the Government of the State and the legislature that the bonds of the St. Lawrence Power Commission would be tax-immune, and they did it, as you will see from this report, on the basis of the *Pollock case*, and all of the other cases, clearly stating the legal situation and the Legislature of the State of New York and the Governor of the State of New York, now the President of the United States, accepted them on the basis of tax immunity. When you have ratified the treaty with Canada, and the St. Lawrence Power Commission proceeds to do the job, it will do it on the basis that the bonds to be issued by the authority are immune from Federal taxes.

Let me call your attention to this point: Every one of these activities that it has been my privilege to be associated with, housing problems and tunnels, port-authority problems, and St. Lawrence Power Commission problems, have all been solved on the basis of low interest rate, and, as one gentleman told you today, Mr. Chatters, low interest is one of the things necessary to the life of these municipal and State ventures.

Now, we come to the conflicting point of view, as I see it. I mean the Treasury's views urging the payment of high interest. There is the lender who wants to get high interest and the borrower who wants low rates. Their interests conflict, but you cannot have high interest rates if you are to obtain the flow of capital necessary to carry on great public projects and create employment. You cannot have high interest rates or secure your low-cost housing, your bridges and tunnels, and low power cost to the public.

What did the mayor of New York mean when he said, "This is the answer to the utilities' prayer"? He meant that every handicap that interferes with reaching his goal, and this interest rate, precludes the municipality and the State from doing such things.

So you have got their question of public policy. Do you want to impose a burden upon all the States and municipalities in the form of higher costs in the doing of these necessary things, because, perchance, some of them may have been extravagant in some things?

That brings me to another matter. The question has been raised that the Federal Government has been obliged, more and more, to put up money for the States. If the policy urged here is pursued, you force everybody to come down here to the supreme borrowing power, and you will have every municipality and every State asking the Government to supply the money with which to do the things

that they need done, because they will not be able then to raise the money themselves.

That is not sound, not only from an economic point of view, but, as has been pointed out, it is an unsound thing from a social and political point of view.

If you still believe, as we do, that the States are not to be provinces of the Federal Government, and if we are not to have a supervising National Government, covering everything, getting all of the money—if you do not believe in that, you cannot sustain the position urged here by the Department of Justice, and you cannot do it as a matter of public policy, quite apart from the constitutional law.

So, I want to stress that point that if the Federal Government wishes now to stop the doing of those things the State governments and the municipalities ought to do and could not do during the depression—you cannot approve this measure.

Now, if you turn the argument to the interest cost and the burden, that will follow you must be convinced from the economic studies and the statements of all of these financial officers, as to the cost to the States and the municipalities, that they would have to spend much more money, and that they cannot take on such a load.

Senator AUSTIN. There is one brief question: If we should tax the salaries of Federal judges, would we not encounter the law as shown in *Collector* v. *Day* to the same extent that we would encounter the *Pollock* decision, if we taxed the income from State bonds?

Mr. COHEN. Yes, and no. Understand, I am not evading your question. I want to be complete in the answer. If you think that the United States Supreme Court is going to hold that every tax of a salary of an employee or officer is inconsequential because the burden is speculative or conjectural, then you will believe that the Court will reverse *Collector* v. *Day*. If, however, you do not believe that and say that it is a burden and not speculative, you put the salary question in the same field as *Collector* v. *Day*, and you get the same result. Understand, please, that it is only in those cases where there is no real burden that *Collector* v. *Day* does not control. That is confirmed by the recent *Stillwell case*.

There is another qualification you will get in the *Stillwell case*, and in the *Wrightington case*. The Board of Tax Appeals and the circuit court of appeals held that there were some cases where it was clear that it was a burden, and you do not have to show it was a burden, and if you accept the construction of the *Gerhardt case* only in the analogous case of private employees, then you come back to *Collector* v. *Day*. That is all subjudice now.

The CHAIRMAN. Mr. Cohen, do you think you could conclude in a short time tonight?

Mr. COHEN. If I can look over my notes tonight, I think I could conclude very shortly tomorrow.

The CHAIRMAN. We will now recess until 10 o'clock tomorrow morning.

(Thereupon, at 5:10 p. m., the special committee recessed until 10 a. m., Saturday, February 11, 1939.)

TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

SATURDAY, FEBRUARY 11, 1939

UNITED STATES SENATE,
SPECIAL COMMITTEE ON TAXATION OF
GOVERNMENTAL SECURITIES AND SALARIES,
Washington, D. C.

The special committee met, pursuant to recess, at 10:30 a. m., in the committee room of the Senate Finance Committee, Senate Office Building, Senator Prentiss M. Brown, chairman, presiding.

The CHAIRMAN. All right, Mr. Cohen, I have your name here as the next to be heard from, and I believe that you have indicated you desire to make some additional remarks.

STATEMENT OF JULIUS HENRY COHEN—Resumed

Mr. COHEN. Thank you, Mr. Chairman: There are one or two things that I find in going over my notes that I neglected to cover, in the nature of a question that comes from the committee, or, as I shall refer to you here as "coming from the bench," as if you were a court.

The first point that I want to make at this time is that, it is quite obvious that if the White Book construction upon the Constitution is accepted, then there is no constitutional protection against Federal taxation of State and municipal bonds, already outstanding, and we must rely upon the assurance of the Congress.

Now, then the Chairman said that, since it only involved a hundred million dollars there was no danger of the Congress taxing outstanding bonds. As to that you do not know how sorely tempted you may be if we should go into a war, and we seem to be in some such danger now. No matter how scrupulous the Government may be, in its promises now, it cannot know what it may be called upon to do, and it cannot be bound. And it would do what it did with the gold clause in our Federal bonds. And I should like to call your attention in that connection to a quotation from page 103 of the brief:

> Who can say whether a future administration or a future Congress will be as fair-minded as this? Who can say whether a future Congress will hesitate in eliminating that statutory "reciprocity"? The States may have complete confidence in the proponents of this plan, but they respond to the language of Chief Justice Marshall, in *McCulloch* v. *Maryland:*
>
> But is this a case of confidence? Would the people of any one State trust those of another with a power to control the most insignificant operations of their State Government? We do know they would not. Why, then, should we suppose that the people of any one State should be willing to trust those of another with a power to control the operations of a government to which they have confided the most important and most valuable interests?

But the most glaring flaw in the plan of statutory "reciprocity" is the simple fact that it would yield to the Federal Government approximately five times as much at the expense of the States as it would give the States at the expense of the Federal Government. As the economic companion to this brief has demonstrated, after balancing all gains and losses, this "reciprocal" permission to tax Federal income would result in a net loss to the States of about $90,000,000 per year in order to give a net gain to the Federal Government of from $40,000,000 to $90,000,000. Moreover, a quarter of the States of this Union have no net personal income tax at all; and the concentration of Federal bonds in a very few wealthy States would leave the rest with practically nothing to tax. These States would be forced to contribute millions of dollars to the Federal Treasury every year without being able to recover a single cent by reason of the permissive "reciprocal" right to tax Federal income. Of course, as to those States, permission to tax the income from Federal bonds is sheer farce. The same objection applies to the municipalities and other governmental agencies of the States whose securities would be taxed. True, a few of the States might recover one-fifth of their added interest cost, but their municipalities and political subdivisions would have no power to tax the income from Federal securities and they, too, would face the prospect that their gross loss would be their net loss.

The States prefer the constitutional protections, and so do investors.

Now, the next point is this: It was suggested here that there might not be any difficulty for the States which do not now have income-tax laws and which therefore are not in a position to take advantage of the opportunity to tax the Federal bonds, which the proposal would offer them. Of course, if there was nothing but an income tax laid on Federal bonds alone would be discriminatory and therefore clearly unconstitutional. And the people would not adopt such a general State income-tax law. For instance, take the States of New Jersey and Connecticut, which States have no income-tax law, many citizens would have to pay two taxes. There are in the northern part of New Jersey many residents who earn their livelihood in New York who would pay income taxes both in New York and in New Jersey, while those living in southern New Jersey who earn their livelihood in Philadelphia would pay income taxes both in Pennsylvania and New Jersey. This explains why public sentiment in such States as New Jersey is against a State income-tax law. Nor would consent by the Federal Government to State taxation of Federal taxation be a sufficient inducement to persuade States like New Jersey to impose on its people the heavy and unfair burden of double taxation. It is important to avoid discrimination against those States which do not have income-tax laws and which for sound reasons cannot enact them.

Now, it was suggested yesterday that there was a trend of judicial opinions towards the change in the interpretation of the sixteenth amendment. But there is in fact no such trend. Immediately preceding *Helvering* v. *Gerhardt* there was argued the *Bekins case*, which involved the constitutionality of the Bankruptcy Act, in which the United States Supreme Court held it was unconstitutional. Mr. Sumners, chairman of the House Judiciary Committee, obtained leave to argue the *Bekins case* in the Supreme Court, and Mr. Jackson, Solicitor General, appeared in support of the constitutionality. Questions from the bench were directed to whether or not the Congress could tax municipal bonds, and the Solicitor General, in making reply to the question whether the bonds of municipalities would be subject to Federal tax, answered, "No." Certainly the Solicitor General did not believe at that time that there was any "trend" in the United

States in the direction of taxing municipal bonds. He said directly that municipal bonds would not be subject to Federal taxation.

When did the so-called "trend" begin? Did it begin with the decision in the *Bekins case*? Certainly not, because in the case referred to we have a typical illustration that you cannot get at this except by getting the consent of the States, and in the first case the Supreme Court held that there was no consent, and in the second case they found that there was consent.

When, then, did the trend begin? When the White Book of the Department of Justice was written? You cannot find in that book a single case in which the courts hold that municipal bonds could be taxed or that there was a trend in that direction, not one case. I will say this to accent the proposition: Every player of a piano knows that when you have to interpret a great composition you have to read the notes carefully. To get the correct effect of Chopin, Paderewski and the other masters of the piano you must follow the composer where the marks are pianissimo, begin very softly, gradually reaching the climax, where it is marked fortissimo, but if some youngster, sometimes even an infant prodigy starts to play he begins to pump hard immediately and, spoils the composition. The same error is made by some conductors. What we have tried to do is to show you that our friends have read the composition incorrectly. We have studied these opinions and we know that there is no such emphasis as they say there is.

Now when you come to the end of the whole case, like the justices in the United States Supreme Court, you will want to know what is the "end result." What are you going to get out of this thing? There can be no escape from the very able statements and analyses made by Dr. Lutz and Mr. Tremaine.

Now, let us look at this situation: You will have 65 billion dollars of tax exempts outstanding, Federal, State and municipal, and if you are going to include refunding bonds, you will continue to have bonds which are of the same general nature as you have today. If that is true, then where are the 65 billions going except into the so-called "havens"?

Charles Lamb once wrote an essay in which he disclosed that the way roast pig came about was that in China a barn burnt down and after it burned down some Chinamen found burnt pig and, tasting the meat, found it delectable. Thereafter they burned down the barn in order to get roast pig and from that comes the expression, "Why burn down the barn to get roast pig?" Now, the objective here is to stop these havens of escape for rich men and 65 billion dollars and more will be available for them for a long time to come under the present plan. The result will be that the pig will escape from the barn while you are burning it down and in the end you will have burned down your barn and then you will go next door and find your pig in another barn with his tail nicely curled and grinning at you.

You are raising the antipathy of the whole country. The people know what this means, the harm that will be done by this proposal, and you hear it not only from the greatest city in the country, but from the smaller ones like Norristown, Pa.

One other thing I want to cover. You spoke about the present trend of the Congress with reference to the removal of tax immunity from tax-free Federal agencies and securities. May I call your attention

to the fact that every one of those agencies remains legally immune. We have a similar problem with respect to such agencies as port authorities—it is not uncommon for them to make lump-sum payments to the municipality in lieu of taxes. Tax these agencies, and take away this immunity and see what happens: Governor's Island, the Federal Reserve bank, the post offices throughout the country, the Federal post office in New York, and, as I have said the post offices throughout the country, the timber and oil lands would be subject to tax.

The CHAIRMAN. What I meant to infer was this, that the trend seems to indicate a great many people of the country feel and think there ought to be some contribution on the part of the Government in this respect.

Mr. COHEN. There is such a trend in New York, and in New York we are working out a system with reference to the port authority whereby a payment to the city of New York in lieu of taxes comes from the tax-immune agency.

There is nothing immoral about tax exemption. It is a matter solely of public policy. If you do not want to cut down surtaxes there is no sound reason why the dual relationship of the States and the Federal Government should be changed, and certainly you will not do such a radical thing without the consent of the people who are affected by it.

The CHAIRMAN. I would like to have you, in the last few minutes, tell us what your ideas are as to the substantial difference, if any, in the justification, if there is any, for the taxation of State salaries, such as the salaries of the Governors of the States, as distinguished from the taxation of the securities issued by the State, because that undoubtedly is going to be the point before the Senate.

Mr. COHEN. I would like, Mr. Chairman, to have 4 or 5 additional minutes to discuss that field.

Of course, from an economic point of view, there is in some of the cases an attempt to distinguish between the taxation of salaries and the taxation of bonds, and that difference is pointed out in the opinions of the United States Supreme Court, leading to the apparent conclusion that the taxation of salaries of some classes of employees does not necessarily involve a burden on a State, but in the *Gerhardt case*, upon which the Government relies, the particular salaries they involved was held not to be a burden, and taxing of the bonds was held not be justified. Indeed the Court itself makes a clear distinction between taxation of bonds and the particular salaries there in issue.

I rendered an opinion immediately after the decision in the *Gerhardt case* as the general counsel for the port authorities, as to the immunity of our bonds, pointing out this distinction, and I should be very glad to submit to the committee a copy of it.

The CHAIRMAN. I believe that it would be helpful indeed.

Mr. COHEN. I thought that I had a copy of it here, but I find that I do not have it here, but we will be very glad to submit a copy and also a copy of the opinion of the Attorney General making the same distinction.

(The opinions above referred to are as follows:)

LEGAL OPINION ON IMMUNITY OF PORT AUTHORITY BONDS AND REVENUES FROM FEDERAL INCOME TAXATION

Office of Frank C. Ferguson, Chairman

THE PORT OF NEW YORK AUTHORITY,
May 27, 1938.

JULIUS HENRY COHEN, Esq.,
General Counsel, the Port of New York Authority,
111 Eighth Avenue, New York City.

MY DEAR MR. COHEN. In view of the inquiries that have been received from various quarters as to the possible effect of the Supreme Court's decision in *Helvering* v. *Gerhardt* and related cases upon the tax immunity of port authority revenues and bonds, I wish you would, as general counsel, advise me whether you see any reason for changing the views heretofore expressed by you that port authority bonds and revenues are immune from Federal income taxes.

Faithfully yours,

(Signed) F. C. FERGUSON,
Chairman.

THE PORT OF NEW YORK AUTHORITY,
OFFICE OF GENERAL COUNSEL,
New York City, May 31, 1938.

Re: Federal taxation (Port Authority bonds and revenues).

Hon. FRANK C. FERGUSON,
Chairman, the Port of New York Authority,
111 Eighth Avenue, New York, N. Y.

MY DEAR MR. CHAIRMAN: In the past I have advised you that the bonds and revenues of the Port of New York Authority are not subject to income taxes levied by the Federal Government under the United States Constitution in its present form. You have requested me to advise you of the effect, if any, of the recent decision of the Supreme Court in the cases of *Helvering* v. *Gerhardt*, *Helvering* v. *Wilson*, and *Helvering* v. *Mulcahy* (herein referred to as the *Gerhardt cases*), decided May 23, 1938.

In response I beg to advise you that after a most careful study, I find nothing which leads me to modify my prior opinion. My reasons may be stated summarily as follows:

(a) The Court considered only the question of the taxability of salaries.

(b) So far as port authority revenues are concerned, the prevailing opinion expressly disavows any intent to declare them taxable.

(c) So far as port authority bonds are concerned, the prevailing opinion expressly cites the borrowing power as a function typically immune from taxation.

The Court determined at the very outset that the sole point at issue in the *Gerhardt cases* was the taxability of the salaries of certain port authority employees. Mr. Justice Stone, speaking for the majority of the Court and referring to these employees only, says

"A nondiscriminatory tax laid on their net income, in common with that of all other members of the community, could by no reasonable probability be considered to preclude the performance of the function which New York and New Jersey have undertaken, or to obstruct it more than like private enterprises are obstructed by our taxing system. Even though, to some unascertainable extent, the tax deprives the States of the advantage of paying less than the standard rate for the services which they engage, it does not curtail any of those functions which have been thought hitherto to be essential to their continued existence as States. At most it may be said to increase somewhat the cost of the State governments because, in an interdependent economic society, the taxation of income tends to raise (to some extent which economists are not able to measure * * *) the price of labor and materials.

He says that to hold these salaries immune would, so far as the States are concerned, constitute only "a theoretical advantage so speculative in its character and measurement as to be unsubstantial," and reaches the conclusion that a tax on the salaries of employees "derived from their employment in common occupations not shown to be different in their methods or duties from those of similar employees in private industry," is a tax which "neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the State government."

In so doing, he expressly says that no opinion is expressed as to "whether a Federal tax may be imposed upon the port authority itself with respect to its receipt of income or its other activities."

In the prevailing opinion, Mr. Justice Stone discusses generally the immunity of the United States from State taxation and the immunity of the several States from Federal taxation. With respect to the immunity of the States and their instrumentalities, he formulates two guiding principles:

First. That certain functions of the States are immune from Federal taxation by reason of their inherent nature.

Second. That at this inherent immunity does not extend to cases where the burden on the State is "speculative and uncertain" and where immunity from taxation would not afford "tangible protection to the State government."

These are not announced as novel principles changing the settled law. On the contrary, they are said to be deduced from prior cases cited in the opinion. Mr. Justice Black (who concurred with the majority only in the result) stands alone in urging in his concurring opinion that the entire doctrine of State immunity be reexamined.

In considering the question of the taxability of the salaries of port authority employees, the prevailing opinion confines itself to the question whether a tax upon the salaries would burden the functions being performed by the port authority on behalf of the States of New York and New Jersey. To this extent, a change in the Court's attitude is made, since in the past, salaries of State and municipal officers have been held immune merely because they were such officers (*Collector* v. *Day*, 11 Wall. 113; *Brush* v. *Commissioner*, 300 U. S. 352). However, the opinion does not even purport to affect the direct immunity of the State itself in accomplishing its sovereign purposes through the use of State agencies or instrumentalities, or its exercise through them of its borrowing power.

If an attempt were made to tax the bonds or revenues of the port authority, there would be no scope for a holding that the tax would not obstruct the functions performed by the States through the port authority. In such a case the burden would not be "speculative and uncertain" but quite the contrary. The Court would be obliged to hold that this immunity constitutes a "tangible protection to the State government," as compared with its holding in the case of salaries that the immunity there considered involved "a theoretical advantage so speculative in its character and measurement as to be unsubstantial." [1]

The port authority is not a private corporation whose activities and profits inure to the benefit of private individuals. It is a public instrumentality of the States of New York and New Jersey, created solely as governmental machinery through which to finance, construct and operate certain highway facilities and other public improvements in the port of New York district. While it has legal title to its moneys and properties, nevertheless, in the ultimate analysis these moneys and other assets are those of the two States. With respect to these moneys and properties, it is in the position of a trustee for the two States. All of the revenues (after operation, maintenance and debt service, and after setting aside certain sinking funds and other reserves) are held by it for use "* * * for such purposes as may hereafter be directed by the two said States" (sec. 2, C. 48, Laws of N. Y. 1931; sec. 2, C. 5, Laws of N. J. 1931).

A tax upon port-authority revenues would directly affect and reduce moneys available to be expended by the two States for State purposes which, like all port-authority moneys, are held in trust for the two States. Moreover, since revenues set aside as security for bonds and to pay the principal amount thereof cannot be deducted in computing net taxable income under the revenue act, such a tax would reduce the amounts available for these purposes and directly obstruct the functions performed by the States through the port authority in financing public improvements.

Port-authority bonds are quoted on a yield basis. A tax upon the income derived therefrom would reduce proportionately the amount which the port authority could obtain upon issue and sale. It would also increase proportionately the amount of interest which the port authority would have to pay. Here again the burden of the tax and the benefit of the immunity are direct and obvious.

The taxability of port-authority salaries was decided under the second principle laid down by the majority in the *Gerhardt cases*—the principle of burden. In the case of revenues and bonds, the burden is clear, and the only question which can

[1] In the *Gerhardt cases*, no proof was offered as to the effect of the tax, since the courts in the past had held that Federal taxes on State and municipal salaries were invalid without requiring specific proof of the burden. In the case of an attempt to tax bonds or revenues, such proof would be offered, and the burdensome effect would be clearly demonstrated.

arise is as to the inherent nature of the functions performed by the port authority on behalf of the two States.

These functions include, among others, the bond-issuing function, the function of collecting tolls upon highway facilities, and the functions of constructing, operating and maintaining highway facilities and port and harbor improvements.

In an effort to indicate the nature of the State functions which the majority holds immune from Federal taxation upon the basis of the decided cases, Mr. Justice Stone in the *Gerhardt cases* uses a variety of different phrases—"a function which pertained to State governments at the time the Constitution was adopted, without which no State 'could long preserve its existence,' " "the essential operations of government which they have exercised from the beginning," "essential to the maintenance of a State government," "essential to the preservation of State governments," "an indispensable function of the State which cannot be delegated to private individuals," and "any function essential to the continued existence of the State government," as contrasted with "one which could be carried on by private enterprise, and * * * not one without which a State could not continue to exist as a governmental entity."

It will be noted that each time it is indicated that the function must be essential. Also, that in two instances it is suggested that the functions must be such as were exercised by the States at the time the Constitution was adopted, and that in two instances the immune functions are contrasted with those of private enterprise.

The phraseology used by Mr. Justice Stone should be compared with that used by Mr. Justice Roberts in *Allen* v. *Regents*, decided by the Supreme Court on the same day that the *Gerhardt cases* were decided. In the *Allen case* the courts held the operation of a football stadium by a State educational institution to be taxable, because it constituted "the conduct of a business comparable in all essentials to those usually conducted by private owners," and because it was "a business which went beyond usual government functions."

As indicated, both the *Allen* and *Gerhardt cases* were decided the same day. In both cases Mr. Justice Stone and Mr. Justice Roberts were with the majority. Both cases are said to be based upon prior decisions. Clearly the difference in phraseology in the two opinions indicates no intent to lay down different rules—the less so since the nature of the function was directly at issue in the *Allen case* but was not considered as all in the *Gerhardt cases*.

Apparently the Court has a concept, difficult to phrase, as to what constitutes a State as a functioning governmental entity. Both justices, presumably, used different phraseology in seeking to express the same concept, but undue stress should not be placed upon the exact words used in either case. The Court has frequently cautioned the bar that the language of its opinions must be read in the light of its actual decisions (*Puerto Rico* v. *Shell Co.*, 82 L. Ed. 170, 179, and cases cited therein).

It would be unprofitable at the present time to attempt to forecast all of the activities which the Court will hold are comprised within its concept of a State as a functioning governmental entity. In any event it seems clear that at the very least the Court will hold that the functions usually and normally exercised by the States at the time of the adoption of the Constitution are immune from Federal taxation.[1]

The borrowing function (exercised through the issuance of bonds) has been exercised by the States "from the beginning," and one cannot conceive of a State existing as a governmental entity without power to exercise this function both directly and through its political subdivisions or other public instrumentalities.

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[1] In the *Gerhardt cases*, the prevailing opinion (referring to *Collector* v. *Day*, 11 Wall. 113), says "The Court pointed out that the States were in existence as such (governmental) entities when the Constitution was adopted; * * * that it (the Constitution) presupposes the continued existence of the States and their continued performance, free of inhibition by the national taxing power, of 'the high and responsible duties assigned to them in the Constitution * * *.' "

In this connection, the opinion in the *Gerhardt cases*, contains a footnote referring to the *Slaughter-House cases*, 16 Wall. 36, in which cases it was said (at p. 83) with respect to the thirteenth and fourteenth amendments:

"Under the pressure of all the excited feelings growing out of the (Civil) War, our statesmen have still believed that the existence of the States with powers for domestic and local government, including the regulation of civil rights, the rights of person and of property, was essential to the perfect working of our complex form of government. * * *

"But whatever fluctuations may be seen in the history of public opinion on this subject during the period of our national existence, we think it will be found that this Court, so far as its functions require it, has always held, with a steady and an even hand, the balance between State and Federal power, and we trust that such may continue to be the history of its relation to that subject so long as it shall have duties to perform which demand of it a construction of the Constitution, or of any of its parts."

And to *Lane County* v. *Oregon*, 7 Wall. 71, in which it was said that "' * * the people of each State compose a State, having its own government, and endowed with all the functions essential to separate and independent existence," and that "' * * in many articles of the Constitution the necessary existence of the States, and, within their proper spheres, the independent authority of the States, is distinctly recognized."

In the *Gerhardt cases*, indeed, Justice Stone cites the borrowing power as a typical function which is immune from Federal taxation by its inherent nature, saying that immunity from Federal taxation has been upheld where "* * * the function involved was one thought to be essential to the maintenance of a State government: as where the attempt was * * * to tax income received by a private investor from State bonds, and thus threaten impairment of the borrowing power of the State; *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429 * * *."

In the case of *Metcalf* v. *Mitchell* (269 U. S. 514), decided in 1925, Mr. Justice Stone also cited the borrowing power as a typically immune function saying that obligations sold to raise public funds are "so intimately connected with the necessary functions of government, as to fall within the established exemption."

In the present term of the Supreme Court, Chief Justice Hughes writing the majority opinion in *James* v. *Dravo Contracting Co.*, 82 L. Ed. 125, decided December 6, 1937, said: "The uniform ruling * * * has been that the interest upon Government securities cannot be included in gross income for the purpose of an income tax computed upon net income."

In the same case, he said "That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers' Loan & T. Co.*, 157 U. S. 429, 39 L. ed. 759, 15 S. Ct. 673, supra) and which would directly affect the Government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit—considerations which are not found in connection with contracts made from time to time for the services of independent contractors."

You will recall that in 1926, while he was engaged in private practice, Mr. Hughes rendered an opinion to the port authority[1] stating that the Port of New York Authority bonds "are not subject to taxation by the Federal Government," and that "The income of these bonds will be likewise free from Federal taxation * * *."

In *Willcuts* v. *Bunn* (282 U. S. 216), decided in 1931, the Chief Justice again said:

"* * * a tax upon the obligations of a State or of its political subdivisions falls within the constitutional prohibition as a tax upon the exercise of the borrowing power of the State. * * *.

"The limitation of this principle to its appropriate applications is also important to the successful working of our governmental system. The power to tax is no less essential than the power to borrow money, and, in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption from taxation to those subjects which fall within the general application of nondiscriminatory laws * * *.

"In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & T. Co.* (157 U. S. 429, 584-586, 39 L. ed. 759, 820, 821, 15 S. Ct. 673, supra). These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the government. * * *."

The Court there distinguished between the immunity of the interest on State and municipal securities from Federal income taxation and the taxability of profits derived from the sale of such bonds. In the case of a tax on the former, the court found there is a burden—in the case of a tax on the profits "* * * we have nothing but assertion and conjecture." (282 U. S. at p. 231.)

In each of these instances there was cited the case of *Pollock* v. *Farmers Loan & Trust Co.* (157 U. S. 429), in which it was said "It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation."

The *Pollock case* cites *Mercantile National Bank* v. *New York* (121 U. S. 138), in which it was said, "Bonds issued by the State of New York, or under its authority by its public municipal bodies, are means for carrying on the work of the government, and are not taxable even by the United States, * * *."

There is no intimation in the *Gerhardt cases* that the Court will depart from this well established rule relating to the tax immunity of bonds. On the contrary, as I have already indicated, the issuance of bonds to raise public moneys is cited as typically illustrative of immune functions.

[1] This opinion rendered to the port authority did not touch upon the taxability of the salaries of its employees. The Chief Justice therefore found no difficulty in concurring with his four colleagues in the *Gerhardt cases* without departing from the principles expressed in his 1926 opinion.

As to the taxation of revenues—practically the entire income of the Port of New York Authority is derived from tolls levied pursuant to statutory authority for the use of the interstate vehicular bridges and tunnels which it operates. The function performed by the port authority on behalf of the States in collecting these tolls is comparable to the function performed by State officers in collecting fees for licenses issued to motor-vehicle owners and operators. In *Morf* v. *Bingaman* (298 U. S. 407), decided in 1936, Mr. Justice Stone characterized such a fee as a charge for the privilege of using highways maintained by the State, saying, "The manner of its collection, not unlike that of a toll for the privilege of entering and using the highways, definitely identifies it as a charge for the privilege."

They are comparable to other fees imposed pursuant to State law for services rendered to the general public, as for example the "harbor fees" upheld in *Clyde Mallory Lines* v. *Alabama* (296 U. S. 261), which Mr. Justice Stone characterized as "a charge made for the policing of the harbor * * *."

The function of levying and collecting fees and charges of this general type has been exercised by or on behalf of the States from the earliest times, and it is impossible to conceive of a State as a governmental entity without power to exercise such an important function as this. It seems clear that like the borrowing power, it is the type of function which the Court has in mind as clearly essential to the existence of government.

The attitude of the Court on this point is foreshadowed by its observation with respect to taxes upon the income produced by the investments of the States and their political subdivisions and public instrumentalities. In the *Gerhardt cases*, in illustrating the extent to which immunity has been upheld, the majority opinion points out that it has been upheld where an attempt was made "to tax income received from the investments of a municipal subdivision of a State," citing *United States* v. *Balt. & Ohio R. R. Co.* (17 Wall. 322).

As I have already indicated, a tax upon port authority bonds or revenues would directly burden and impair (and perhaps entirely nullify) the ability of the States through the port authority to perform the functions of constructing, maintaining, and operating interstate vehicular bridges and tunnels. These vehicular crossings are part of the highway systems of the two States. The function of providing and maintaining adequate streets and highways has been a function exercised by the States "from the beginning," and is one of their most important functions. Without our public highway systems, the country could never have developed.

The power to build and maintain public highways, either directly or through appropriate public instrumentalities, has always been a characteristic of the States, and this important function meets every test of a State function which by reason of its nature is immune from Federal taxation.

In conclusion, mention should be made of the fact that the prevailing opinion in the *Gerhardt cases* contains the passing comment that the Port of New York Authority is not a political subdivision within the meaning of the phrase as used in the section of the Treasury Department Regulations in effect prior to January 7, 1938, which provided that "compensation received for services rendered to the State or a political subdivision thereof," should not be included in gross income for tax purposes under certain circumstances. The Court at first pointed out that the revenue act did not authorize "the exclusion from gross income of the salaries of employees of a State or a State-owned corporation."

As an additional reason why the above-quoted regulation was not in point, the Court then made the passing comment that Port Authority employees were not employees of the State or a political subdivision thereof "within the meaning of the [above quoted] regulation."

The immunity from taxation, however, which is discussed in the *Gerhardt cases* and in my present opinion, is not an immunity which arises either from the Treasury Department Regulations or from the revenue act. It arises from the Federal Constitution.

The immunity of the States and their agencies from Federal taxation cannot be cabined within the limitations of the term "political subdivision" either by regulation of the Treasury Department or an act of Congress.

If an attempt is made to tax the bonds or revenues of the port authority, the question before the Court will not be whether it is a political subdivision within the meaning of the regulations or the act, bu whether the functions burdened by the tax are of a type immune from taxation. As indicated, I am of the opinion that the Court will not depart from the established rules of constitutional law but instead will hold port authority bonds and revenues immune from taxation.

In this connection, the language in *United States* v. *Balt. & Ohio R. R. Co.* (17 Wall. 322) (where municipal investments were held to be immune from taxa-

tion) is significant. The Court said: "It is not necessary to discuss the question whether this city is a municipal corporation."

It said that the test was whether the city was "acting in its capacity of an agent of the State, delegated to exercise certain powers for the benefit of the municipality called the city of Baltimore."

The Court asked: "Did it act as an auxiliary servant and trustee of the supreme legislative power?"

There is no reason to believe that the Supreme Court of the United States will at any time countenance the destruction of the essential sovereignty of the State through Federal taxation of the revenues or the borrowing power of the State, its political subdivisions or public instrumentalities. It must never be forgotten that the power to raise revenues and the power to borrow moneys are necessary to the very existence of any government. Without these powers no government could exist.

Respectfully submitted.

(Signed) JULIUS HENRY COHEN,
General Counsel.

THOMSON, WOOD & HOFFMAN,
ATTORNEYS AND COUNSELORS AT LAW,
New York City, May 31, 1938.

Hon. FRANK C. FERGUSON,
Chairman, Port of New York Authority,
111 Eighth Avenue, New York City.

DEAR MR. FERGUSON: We have read the opinion of the honorable Julius Henry Cohen of even date herewith and for the reasons expressed therein we are of the opinion that the income on the bonds of the Port of New York Authority and the revenues of the Port of New York Authority are exempt from Federal income taxes under the Constitution of the United States as now in force.

Very truly yours,

(Signed) THOMSON, WOOD & HOFFMAN.

OPINION ON IMMUNITY FROM FEDERAL INCOME TAXES OF THE REVENUES AND BONDS OF THE PORT OF NEW YORK AUTHORITY

By JOHN J. BENNETT, Jr., Attorney General, State of New York

STATE OF NEW YORK
DEPARTMENT OF LAW
ALBANY

JOHN J. BENNETT, Jr.
Attorney General

JUNE 24, 1938.

Hon. MORRIS S. TREMAINE,
State Comptroller, Albany, N. Y.

DEAR SIR: I am in receipt of your communication of June 16, 1938, in which you state that "recent decisions of the Supreme Court of the United States (*Helvering* v. *Gerhardt; Helvering* v. *Wilson; and Helvering* v. *Mulcahy*), 82 L. Ed. (adv. ops.) 902, decided May 23, 1938, have caused inquiries to be made concerning the tax immunity of revenues and bonds of the Port of New York Authority." You ask for my opinion on the tax immunity of the revenues and bonds of the Port of New York Authority.

After a most careful study of the various pertinent opinions of the Supreme Court of the United States, I am firmly of the opinion that both the tolls and revenues of the Port of New York Authority, and the interest paid by it upon its bonds, are immune from Federal taxation under the United States Constitution as now in force.[1] The most recent opinions of the Supreme Court, as well as those from the earliest date, reaffirm the principles upon which this constitutional immunity is based. In the following discussion I shall consider (1) the immunity from Federal income taxes of the interest derived from special revenue bonds of

[1] I have heretofore expressed the opinion that the interest upon these bonds is immune from Federal taxation. See opinion of February 8, 1934, addressed to department of taxation and finance. See also opinion of June 15, 1936, addressed to State comptroller advising that bonds of the Buffalo and Fort Erie Public Bridge Authority are immune. My present opinion sets forth more fully the reasons for my conclusion with respect to bonds, and also gives my opinion with respect to revenues.

the type issued by the Port of New York Authority and similar agencies; and (2) the immunity of the tolls and revenues of such agencies from Federal income taxes. These will be viewed: First, from the standpoint of the Federal Constitution (the relation of the sovereign States to the National Government, and the bases of the immunity derived therefrom); second, from the statutory viewpoint, the immunity of the tolls and revenues, as well as the interest on special revenue bonds issued by such authorities, under the existing revenue acts.

THE CONSTITUTIONAL IMMUNITY OF THE INTEREST FROM SPECIAL REVENUE BONDS ISSUED BY STATE AGENCIES AND OF THE TOLLS AND REVENUES OF SUCH AGENCIES

The doctrine of the immunity of the States and their agencies from Federal taxation arises from the inherent nature of our form of Government which is a Federal system consisting of a National Government and various State governments. The National Government on the one hand, and the States upon the the other, are each sovereign and supreme in their own spheres. The taxing power can be used as a means of regulation,[1] and to permit one government to be taxed by another would be to make it subordinate and subject to the one exercising the taxing power. As the United States Supreme Court has itself pointed out, the Constitution presupposes the continued existence of the States as governmental entities [2] endowed with all the functions necessary to separate and independent existence (*Helvering* v. *Gerhardt*, 82 L. Ed. (adv.ops.) 902, decided May 23, 1938; *Collector* v. *Day*, 11 Wall 113; *The Slaughter-House cases*, 16 Wall 36; *Lane* v. *Oregon*, 7 Wall 71). For this reason, the Court has consistently held that any attempt by the National Government to levy taxes which would burden or obstruct the States in the performance of these functions is entirely repugnant to the Constitution.

That the power to raise funds for public purposes is most essential to the continued existence of the State, is not open to question. Without it, no government could long exist. As was said by Hamilton in The Federalist, No. 30:

"Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion, and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of it, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution. From a deficiency in this particular, one of two evils must ensue; either the people must be subjected to continual plunder, as a substitute for a more eligible mode of supplying the public wants, or the Government must sink into a fatal atrophy, and, in a short course of time, perish."

Hamilton was, of course, arguing for a constitutional grant to the National Government of power to raise moneys for national purposes. He had already characterized the lack of such power as a "great and radical vice in the construction of the existing confederation." He was not, however, arguing that such power should be granted at the expense of the States, but recognizing that the States already had this essential power, he was arguing that the National Government needed it likewise (The Federalist, No. 15).

The essential power to raise funds for public expenditure may be exercised in a variety of ways. It includes not only the power to levy and collect taxes and assessments for public benefits, but also the imposition of fees of various kinds, and the raising of funds upon bonds or other obligations.

The United States Supreme Court has frequently stated that the borrowing power, exercised through the issuance of bonds by the State or its public agencies, is so essential to the State that the interest paid upon such bonds is immune from Federal taxation. In the *Gerhardt case*, *supra*, the prevailing opinion, citing *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, says that the bond issuing function "was one thought to be essential to the maintenance of a State government" and that to tax income received by a private investor from State bonds would "threaten impairment of the borrowing power of the state."

[1] Illustrations of the exercise of the taxing power as a means of regulation include protective tariffs, taxes imposed on the undistributed profits of corporations, and the taxes imposed in some States upon chain stores.

[2] The continued existence of the States depends not only upon constitutional grounds but also upon fundamental considerations of public policy. The territorial extent of the Nation, and the diversities of industry and climate, as well as the differences in opinion held by the inhabitants of different sections, are such as to make necessary the existence of the States as self-governing entities. The instinct of our people for local self-government finds expression among other things in the "Home Rule" provisions of our State constitution. If the States had not existed as governing entities at the time of the adoption of the Constitution, it would have been necessary to invent them.

Mr. Justice Stone who wrote the prevailing opinion in the *Gerhardt case* also wrote the prevailing opinion in *Metcalf* v. *Mitchell* (269 U. S. 514), in which it was said that obligations sold to raise public funds are "so intimately connected with the necessary functions of government, as to fall within the established exemption."

In *James* v. *Dravo Contracting Co.*, 82 L. Ed. (adv. ops.) 125, decided by the Supreme Court only last December, the prevailing opinion refers to "the uniform ruling" that interest on Government securities is not subject to income taxes, and says:

"That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers' Loan & T. Co.*, 157 U. S. 429, 39 L. Ed. 759, 15 S. Ct. 673, *supra*) and which would directly affect the Government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit—considerations which are not found in connection with contracts made from time to time for the services of independent contractors."

The opinion in the *Dravo case* was written by Chief Justice Hughes,[1] who also wrote the opinion in the case of *Willcuts* v. *Bunn*, 282 U. S. 216, in which he said:

"* * * a tax upon the obligations of a State or of its political subdivisions falls within the constitutional prohibition as a tax upon the exercise of the borrowing power of the State. * * *.

"In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & T. Co.* (157 U. S. 429, 584–586, 39 L. ed. 759, 820, 821; 15 S. Ct. 673, supra). These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government. * * *"

The Chief Justice drew a line between taxing the interest paid upon bonds issued by the States or their public agencies, and taxing the profits derived upon the resale of such bonds by a holder, pointing out that a tax upon the interest directly burdens the borrowing power of the State, whereas the effect upon the borrowing power of a tax upon such profits is purely conjectural.

In the *Pollock case*, it was said:

"It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation."

and in *Mercantile National Bank* v. *New York* (121 U. S. 138), it was said:

"Bonds issued by the State of New York, or under its authority by its public municipal bodies, are means for carrying on the work of the government, and are not taxable even by the United States, * * *."

In none of these cases is any distinction made between bonds issued directly by the State and those issued by its political subdivisions or other public agencies to raise public funds pursuant to State law, and in my opinion no sound basis for such a distinction can be found.

The Port of New York Authority is one of a group of State agencies, sometimes generically referred to as "authorities," created by the State, like cities and counties, to facilitate the carrying on of State functions. In this group are included, among others, the Triborough Bridge Authority, Buffalo and Fort Erie Public Bridge Authority, the Lake Champlain Bridge Commission, the New York State Bridge Authority, and many others.

In each of these instances, the primary motive leading to the creation of the authority has been to provide an appropriate method of financing public improvements.[2]

The result both from the legal and the practical standpoint, has been that moneys to construct the public improvement have been provided through the issuance of bonds secured by and payable solely from the revenues of the public improvement. Precisely the same result would have been reached if the State had exercised its borrowing power directly—issuing its own special revenue bonds with a provision that they should be secured by and payable from the revenues of the public improvement, and that the holder should have no recourse against any other moneys or assets of the State.

[1] In 1923, Mr. Charles E. Hughes, rendered an opinion to the Port of New York Authority, advising that its bonds would be exempt from both Federal and State taxation.

[2] In the case of certain of the authorities mentioned, there was the additional motive resulting from a desire to create a single agency to act for two governments (e. g., New York and New Jersey, New York and Vermont, New York and the Dominion of Canada).

These so-called authorities are not separate from the State and sovereign in their own right, as the State is separate from the National Government and independently sovereign. They are but creatures of the State or States which brought them into existence, and constitute but a convenient method whereby the State exercises its borrowing power and other functions.

They differ from cities, counties, and incorporated villages in that the powers vested in them by the State are limited to a more restricted field. For example, the State Bridge Authority has powers only with respect to certain bridges which form part of the State highway system. Counties have powers with respect to highways but also have many other powers. In this respect, the so-called authorities are like school districts and other districts created by the State for limited and specific purposes.

From the standpoint of the exercise of the borrowing power, I can no more distinguish between the bonds issued by one of these authorities and special revenue bonds issued by the State, than I make distinction between bonds issued by a municipality and bonds issued in the name of the State, but payable only from the taxes and revenues received by such municipality.

From the legal standpoint, these authorities are trustees and agents of the State, exercising its borrowing power pursuant to its authority and on its behalf. From the practical standpoint, the proceeds derived from the sale of such bonds are as much subject to the disposition of the State as though the bonds had been issued by the State itself.[6]

I find nothing in any of the opinions of the Supreme Court which suggests that the immunity of the State borrowing power from Federal taxation is dependent upon the purposes for which it is exercised. Such a doctrine would permit the National Government (through the exercise of the taxing power) to control and override the legislative determinations of the States. It would enable the National Government to regulate the States in their performance of the functions reserved to them under the Constitution.

The argument that a tax upon the interest paid by the State upon its bonds is a tax upon the holder and not upon the issuer, and that therefore the immunity accorded to the State's borrowing power does not extend to such a situation, is in my opinion unsound. It ignores the "vital considerations" mentioned in the *Dravo case* "respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit." A tax upon the interest paid by the State upon its bonds would directly affect the amount received by the State on the sale thereof and the amount paid by the State throughout the lifetime of the issue in the form of interest. Such a tax would mean that the State would receive less moneys upon the original sale, and would pay out larger sums in the form of interest. These burdens are not in any sense speculative and uncertain, but are evident, direct, and universally recognized.

I must emphasize that the case of *Helvering* v. *Gerhardt*, *supra*, contains nothing whatsoever to indicate a holding that the bonds of the Port of New York Authority or of any other political subdivision or public agency of the State are subject to Federal taxation. In that case, the Court held only that the salaries of certain Port Authority employees were taxable. The prevailing opinion bases this result upon the ground that a tax upon the salaries of employees "neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the State government" and that "a nondiscriminatory tax laid upon their net income in common with that of other members of the community could by no reasonable probability be considered to preclude the performance of the function which New York and New Jersey have undertaken."

This case indicates that the State immunity may not be extended to situations where (as in the case of salaries of employees) the Supreme Court considers the burden on the State to be speculative and conjectural.[7] In the case of bonds, a very different situation is presented. The Court would be forced to find that the burden would not be speculative and uncertain. In such case the immunity from taxation would, in the phraseology of the *Gerhardt case*, constitute such a "tangible protection to the State government" as to come within the immunity doctrine.

In the foregoing portion of this opinion, I have considered the general question of the taxability of interest upon bonds of the Port of New York Authority,

[6] In the case of the Port of New York Authority, specifically, the statutes provide that any tolls or revenues remaining after operation, maintenance, debt service, etc., can be expended only "for such purposes as may hereafter be directed by the two said States" (ch. 46 of New York of 1931; ch. 5 of New Jersey of 1931).

[7] A motion for a reargument of the *Gerhardt case* on this and other points has been made, and a stay has been granted by the Supreme Court pending the motion.

whether such bonds be held by the State or by a private investor. I have done so because the taxability of such interest in the hands of a private investor directly affects the market price of the bonds and I have assumed that you are interested in the market value of the bonds held as investments by the State, as well as the question whether the interest therefrom received by the State itself is subject to Federal taxation. I should add that in my opinion the interest received by the State or its political subdivisions or other public agencies upon their investments (even though the investments are the obligations of private corporations) are not subject to Federal taxation. In the *Gerhardt case, supra*, it is said that the doctrine of immunity from Federal taxation extends to cases where an attempt is made "to tax income received from the investment of a municipal subdivision of a State," citing *United States* v. *Balt. & Ohio R. R. Co.*, 17 Wall. 322. A fortiori the income received by the State itself from its investments is immune.

Turning now to the question of the taxability of tolls and revenues received by the port authority, which constitute the security for and source of payment of its bonds, I am of the opinion that, like interest paid upon the bonds, these tolls and revenues are immune from Federal income taxes under the Constitution of the United States as now in force. In the *Gerhardt case, supra*, the four justices who comprised the majority, expressly disclaimed any attempt to pass upon the question "whether a Federal tax may be imposed upon the port authority itself with respect to its receipt of income or its other activities," but to my mind other pronouncements of the Supreme Court make it clear that such a tax would be held invalid if an attempt were made to impose it.

In the *Gerhardt case*, the prevailing opinion states that the essential operations of the State governments which they have exercised from the beginning are immune from Federal taxation. It contrasts such functions with those which could be carried on by private enterprise and which are not ones without which the States could continue to exist as governmental entities. This opinion cites *Collector* v. *Day; The Slaughter-House cases*, and *Lane County* v. *Oregon, supra*, where stress was laid upon the fact that the Constitution presupposes the continued existence of the States and their continued performance, free of inhibition by the national taxing power of the high and responsible duties assigned to them under the Constitution. The cases cited above clearly indicate that the Supreme Court has no disposition to uphold Federal taxation of those functions of the State governments which are deemed to be necessary attributes of them as governing entities.

It is unnecessary in this opinion to list all of the State functions which come within this definition. It is enough to point out that since the rule derives from the fact that the Constitution assumes the continued existence of the States, the list must of necessity include all functions normally and usually exercised by the States at the time of the adoption of the Constitution. From the standpoint of the Constitution, the States as governing entities must at least be deemed to retain those attributes which they possessed at the time of its adoption.

As indicated above, the States have always possessed the power, obviously essential to their very existence, to raise public funds for public purposes. The borrowing power discussed earlier is but one phase. The general power includes the power to raise moneys through the levying of taxes, through the levying of assessments for benefits, through the charging of fees, and in other ways.

The *United States* v. *Balt. & Ohio R. R. Co., case, supra*,[8] which held unconstitutional taxes upon revenues of a city derived from its investments in railroad bonds, is based upon the fact that the revenues in question were public revenues. The court said:

"We admit the proposition of counsel that the revenue must be municipal[9] in its nature to entitle it to the exemption claimed,"

and points out that if the city should assume to act as a trustee or a private individual, a different situation would arise, saying:

"The corporation would therein depart from its municipal character,[10] and assume the position of a private trustee. It would occupy a place which an individual could occupy with equal propriety. It would not in that action be an auxiliary or servant of the State, but of the individual creating the trust. There is nothing of a governmental character in such a position. It is not necessary, however, to speculate upon hypothetical cases."

The Court pointed out that what was actually involved was "an investment" made "for the benefit of the city solely," and concluded:

[8] Cited in the prevailing opinion in the *Gerhardt case*.
[9] The Court uses the word "municipal" as synonymous with "public."
[10] See *supra*, footnote 9.

"We are clear in the opinion that the present transaction is within the range of the municipal duties of the city, and that the tax cannot be collected."

I am firmly of the opinion that all revenues of the State which are of a public nature are immune from Federal taxation, and that this rule applies equally to the revenues of its political subdivisions and other public agencies. Apparently the only exception which the Court will make to this general rule has been in the cases where the State has undertaken an enterprise which from any standpoint is characteristically private in its nature—such as the operation of retail liquor dispensaries, *Ohio* v. *Helvering* (292 U. S. 360), and of football stadia, *Allen* v. *Regents* (82 L. ed. (adv. ops.) 975), decided May 23, 1938.[11]

It is clear that the Federal Government has no constitutional power to impose taxes upon a State or any agency thereof with respect to its income derived from State or local taxes. It is equally clear that such a tax could not be imposed with respect to moneys secured from assessments for benefits, from gasoline taxes, or from fees charged by the State department of taxation and finance for licenses issued to owners and operators of motor vehicles. Fees similar to those last mentioned have been characterized by the Supreme Court itself as a charge for the privilege of using highways maintained by the State, comparable to a toll for the privilege of entering and using highways. *Morf* v. *Bingaman* (298 U. S. 407). The tolls charged by the two States through the agency of the Port of New York Authority for the privilege of using the interstate vehicular bridges and tunnels which form part of their State highway systems stand upon the same plane.

Practically all of the revenues of the Port of New York Authority are derived from the operation of these interstate vehicular bridges and tunnels. As indicated above, the construction, operation, and maintenance of these portions of the State highway systems is one of the most important functions performed by the two States through the agency of the port authority.[12] Providing adequate public highway facilities has been a normal and usual function exercised by the State since colonial days either directly or through their political subdivisions or other public agencies.[13]

A tax upon the tolls collected by the port authority would not only be a tax upon public revenues derived from tolls charged as a fee for the privilege of using State highway facilities, but would directly burden and impair the function performed by the States, through the port authority, in constructing, maintaining, and operating their public highways.

THE IMMUNITY OF THE INTEREST FROM SPECIAL REVENUE BONDS ISSUED BY STATE AGENCIES AND OF THE TOLLS AND REVENUES OF SUCH AGENCIES UNDER THE REVENUE ACTS

In the preceding part of this opinion, I have confined my attention to the constitutional questions involved. As indicated, I am of the opinion that the revenues of the Port of New York Authority and the interest paid by it upon its bonds are immune from Federal income taxes upon constitutional grounds. I should add that in my opinion they are also exempt under the Revenue Acts of 1936 and 1938. Section 22–B of the act of 1936 provides:

"The following items shall not be included in gross income and shall be exempt from taxation under this title:

"(4) Interest upon (A) the obligations of a State, territory, or any political subdivision thereof * * *."

Section 116, subdivision (d), of the act provides that:

"Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, territory, or the District of Columbia, or any political subdivision of a State or territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof,"

shall be exempt.

These provisions exemplify a policy which Congress has followed with great consistency—a policy of exempting public officers and bodies from requirements

[11] The taxes upheld in *Ohio* v. *Helvering* and *Allen* v. *Regents* were excise taxes, not income taxes.

[12] The Holland Tunnel was not constructed by the port authority although it is now maintained and operated by it. It was originally constructed by the two States themselves, acting directly through their respective tunnel commissions. The original Holland Tunnel treaty provided that the gross revenues of the tunnel should be paid directly into the State treasuries. It was not until 1931, that the duty of collecting tolls upon this tunnel was transferred to the port authority in aid of its exercise of the borrowing power of the two States.

[13] The minutes of the common council of the city of New York in the period from 1675 to 1776 show that at that time the city was exercising the governmental functions of building roads—see typically minutes of the common council on January 4, 1765, at p. 404, vol. 6, Minutes of the Common Council of the City of New York, 1675–76, published in eight volumes, 1905, under the authority of the city of New York.

which it is deemed necessary to impose upon private persons and corporations. This policy is seen in the provisions of the National Banking Act, where public bonds are made exempt from the restrictions placed upon national banks in underwriting or dealing with securities. It is seen in the Social Security Act, where the States and their political subdivisions and instrumentalities are exempted from the requirements of the act. It is seen in title 2 in the National Industrial Recovery Act and subsequent legislation where grants are authorized to States, municipalities, and other public bodies, but not to private individuals or private corporations. It is seen in the Wagner Labor Act which does not apply to the States or their political subdivisions. It is seen in the Securities Act of 1933 and in the Securities Exchange Act of 1934, neither of which apply to securities issued by the States or their political subdivisions or instrumentalities. The wages and hours bill will not apply to the States or their political subdivisions.

In making a distinction between the States and their public agencies on the one hand and private individuals and private corporations on the other, Congress is but recognizing an underlying and fundamental difference between governmental affairs and private business. I do not mean to imply that Congress has invariably exempted public bodies from the purview of Federal legislation, but I do feel that the attitude of Congress in this regard is so well established and is based upon such obvious grounds of public policy that consideration must be given to it in interpreting the revenue acts.

I can conceive of no reason which would lead Congress to make distinctions between different types of State agencies from the standpoint of taxes upon their revenues or the interest upon their bonds. For example, if the State should decide to divest itself of its governmental character and enter upon a business that is purely private in its nature (as the retail sale of liquor has been held to be), I can conceive of no reason which would lead Congress to say that the profits derived from such a business enterprise should be exempt from income taxes if the business was carried on directly by the State or a county, but that they should be subject to taxation if the State created a special agency for the purpose. To find such an arbitrary intent in the Revenue Act of 1936 is to assume that Congress in adopting that act intended to regulate and restrict the States in their method of carrying on public affairs. Whether or not such power to regulate the States exists I cannot believe that the revenue acts represent an attempt to do so.

Classification for tax purposes must be reasonable, and a distinction between public bonds and public revenues on the one hand and private bonds and private revenues on the other is an eminently reasonable classification. A distinction between bonds issued pursuant to State law to raise public funds for highway improvements, dependent solely upon the type of public agency which the State elects to use as its bond issuing instrumentality, would, in my opinion, be unreasonable.

Lastly, it must be said that the phrase "political subdivision" is not a term of art having a precise meaning. Like the phrase "municipal corporation," its meaning is vague and uncertain, and must usually be sought in the context and the surrounding circumstances. I have heretofore expressed the opinion [1] that the Buffalo and Fort Erie Public Bridge Authority is a political subdivision of the State within the meaning of the section of the New York State income tax law which exempts "interest upon the obligations of the State of New York or of any municipal corporation or political subdivision thereof." See for example: *People ex rel. Buffalo & Fort Erie Public Bridge Authority* v. *Davis, et al* (277 N. Y. 202), and *Gaynor* v. *Marohn* (268 N. Y. 417).

I reached this conclusion because I could not impute to the legislature of this State an intent to make an arbitrary and unsound distinction between different types of public obligations. For the same reason, I am of the opinion that the Port of New York Authority and similar public agencies are within the intent of the provisions of the revenue act exempting public revenues and the interest upon public bonds from Federal income taxes.

In reaching this conclusion, I am not unmindful of the fact that the prevailing opinion in the *Gerhardt case, supra*, contains a passing dictum to the effect that the port authority is not "a political subdivision within the meaning of the regulation—of the Treasury Department—as originally promulgated." The regulation of the Treasury Department in question purported to create an exemption in favor of employees where none was provided in the revenue act itself. This

[1] See opinion of May 31, 1934, to Hon. Seth T. Cole, deputy commissioner and counsel, department of taxation and finance.

much, however, cannot be ignored: Still another article of the Treasury Department Regulations (reg. 86, art. 22 (b) (4)–1, 1934; reg. 94, art. 22 (b) (4)–1, 1936) [11] defines the term "political subdivision" as including port and harbor districts and it is to be presumed that the long continued existence of these regulations has been acquiesced in by the Congress.

In conclusion, therefore, I beg to advise you that the revenues of the Port of New York Authority, and the interest paid upon its bonds, like those of other State agencies, are immune from Federal income taxes both on constitutional and statutory grounds.

Very truly yours,

(Signed) JOHN J. BENNETT, Jr.,
Attorney General.

Mr. COHEN. Here is the situation that we face. Here are $200,000,000 of free bonds, and the Court held our bonds taxable, and we examined the opinion in the *Gerhardt case* and wrote a very careful opinion on it, and that opinion points out, first of all, as this brief signed by the Attorney General points out, that there has been no difference of opinion in the United States Supreme Court from the beginning to the end as to the immunity of bonds, and in the next place we point out that in the *Gerhardt case* that distinction was made and the reasons therefor you will find in the opinion. But the Court says, as to taxation of salaries, the burden is speculative and uncertain. Judge Roberts said, on the other hand, in the Roberts—Oh, yes, in the *Brushaber case* that the burden of a tax upon the income from bonds was not speculative, but was real. Sometimes we fall into the error of the misuse of words. When we say "damages must be ascertained by the jury," we do not mean to convey the idea that the damages are too speculative to be determined, but rather that the jury has the task of determing what the damage is.

You are familiar with the figures of Dr. Lutz; we think they are conservative; we base it on the observation of other experts. The Supreme Court has recognized that there is a burden in the case of bonds. But as to salaries they say the burden is not a burden upon the State as to certain classes of employees since the employee pays it out of his own pocket, and it may not come out of the State. I can see by the expression on Senator Austin's face that he is not convinced by that argument. May I say I am not convinced personally, but that is beside the point we are now considering, as to whether the courts will continue to extend that exemption further, and the Circuit Court of the Eighth Circuit refused to extend the *Gerhardt case*; the Board of Tax Appeals has refused to extend it because they say that proof of burden is not required in the case of clearly governmental officers.

The CHAIRMAN. Is this the situation, that is, if the sixteenth amendment has not changed the rule in *Collector* v. *Day*, then the bill passed by the House the other day would be clearly unconstitutional?

Mr. COHEN. Right. In other words, what you are faced with is that if you interpret the Constitution of the United States as they want you to and say that the sixteenth amendment means "from whatever source derived," as that includes any compensation or any interest on a bond, then you are putting upon the Constitution an interpretation that leans clearly against all these cases and you imperil the situation with reference to the securities of this country, with reference to revenue, and that is the reason why the lawyers here are fearful that if you put an interpretation such as asked for, you are imperiling the whole structure of our Government.

[11] The 1938 Revenue Act is identical in this respect.

The CHAIRMAN. I think you have made your position sufficiently clear.

Mr. COHEN. May I go back to one feature of my statement in order to wind up my argument? I ask you gentlemen to bear in mind when you come to study this record, as a court, after getting the briefs and arguments: That a revocable privilege in exchange for an absolute power is not a reciprocal relationship; reciprocal immunity is equitable and mutual, but that is not reciprocity, which is one-sided and which presumes to exchange a mere withdrawable consent for the permanent surrender of a sovereign power.

Your own counsel has pointed out the only safe way to work that out.

Who appears in support of this proposition? Any State by its governor or attorney general, any city by its mayor and any official or officer of any city, and any bona fide officer of any State. Who appears in support of this? Why have fears been expressed? We are disturbed because we have duties to those to whom we have sold our bonds—we have a duty to act in good faith; and we have "further duty to preserve the States in their sovereign powers."

The CHAIRMAN. Thank you, Mr. Cohen. I want to correct one statement that you made. I do not want it to be stated that I am committed to the proposition of allowing further exemption of the interest on State or municipal bonds. I made that as a suggestion only, but I did not mean to say that I had necessarily reached that conclusion.

Mr. COHEN. If I gave you that impression, I ask to be permitted to withdraw it and make it clear that I did not so understand you.

The CHAIRMAN. Certainly, Mr. Cohen.

Mr. Marsh, the committee will allow you 10 minutes to make your observations at this particular time.

STATEMENT OF BENJAMIN C. MARSH, EXECUTIVE SECRETARY OF THE PEOPLE'S LOBBY, WASHINGTON, D. C.

Mr. MARSH. The name is Benjamin C. Marsh, executive secretary of the People's Lobby with headquarters here in Washington. I would like first to read a brief statement, and express the hope that if there be questions that the time so consumed will be added to the time allotted me.

The government bonds were issued, tax exempt, primarily to keep down the alleged cost of Government operation, as the low tax rate gave the appearance of a very low cost of public ownership financed through bonds. This illusion disappeared as the loss to the Government from the sort of income taxes that would be levied upon incomes of large holders of Government bonds, tax exempt, is being appreciated.

I might put it this way more concisely. America is permitting itself to be bankrupt because of its policies.

I saw Governor Hughes quite a bit, because when he was governor he appointed me to an unpaid job as secretary of a State committee on distribution of population. I appreciate thoroughly the significance of his statement as Governor that "the Constitution is what the judges say it is," but the constitution cannot supersede economics, and we are in the most serious position in our country's history, so serious

that we are arming to see our way out with the suggestion that the Lord will provide an enemy.

The suggestion made by Mayor LaGuardia that the Federal Government should remit to the cities and States revenue which the Government derives from taxing interest on State and local bonds is thoroughly vicious. The untaxed selling price of taxable land in New York City is over seven billions of dollars. A 1-percent tax upon this untaxed value of taxable land in New York City would be $70,000,000. Mayor LaGuardia's plea would be just an added bonus to the land speculators of the city who run it today as they have in the past.

Now, let me call this to your attention, that Mayor LaGuardia and others have been here to Congress from time to time asking for hand-outs, and New York City is now getting a big hand-out from the Federal Government.

Taxing income from Government bonds will tend to force cities and States to a more intelligent tax system, as current budgets will reflect more fairly the actual outlays which Government is incurring.

Mr. Cohen remarked during his address to the committee that we here are lawyers. I am not a lawyer, but I do know that no law enacted by any legislative body can repeal any economic law, which, after 6 years of New Deal administration and legislation is at least seeping through to the conscience of the American people.

Please allow me to call your attention to a statement made by the Twentieth Century Bulletin, entitled "Debts and Recovery" because they reach the same conclusion which I think the committee should keep in mind. They state that it is estimated that individuals hold about $50,000,000,000 worth of bonds in 1934, which has fallen slightly since, and that "tax-exempt holdings of well-to-do individuals range from $10,000,000,000 to $15,000,000,000 while relatively little is held directly by persons in the lower brackets," and I would feel like a snake and traitor to have tax-exempt bonds while others are paying Federal, State, and local taxes.

The CHAIRMAN. How could you remove that feeling? By selling the bonds and buying something else in their place?

Mr. MARSH. Then I make somebody else do it. You cannot change a system of that kind by simply letting the other fellow do that part of it. "The committee is emphatically of the opinion that while sounder debt policies can help to forestall depressions and ease crises, they cannot alone bring recovery."

I recently analyzed a capital set-up of corporations, and I found rather striking figures, using the last figures then available. At the close of 1935, the latest year for which the Bureau of Internal Revenue has published final figures, the total reported assets of 415,205 corporations which returned balance sheets shows $303,150,231,000. Of the total reported net profit less total tax of the 415,205 corporations covered, amounting to $4,778,059,000, the uppest one sixth-hundredth got $2,875,706, or over three-fifths, and of the cash dividends paid amounting to nearly $5,900,000,000 they accounted for a little under half—almost $2,700,000,000.

In addition, they had approximately $14,000,000,000 of tax-exempt investment. Now we are fast running the country into debt, at least three and a half billion dollars a year. You have got to raise money, and you cannot keep on borrowing forever and a day.

I am not a lawyer, but I have studied the English language, and it seems to me that it is quite obvious that the constitutional amendment, which provides that the Government can tax income from whatever source derived, means just what it says.

Of course, I know what the real issue is. I have had the pleasure of knowing Mr. Cohen for many, many years, and he is very plausible and a good lawyer. This is not basically a legal question, as we see it, because whether a constitutional amendment is needed or not, the question is: Are you going to continue to raise about two-fifths of the total cost of the Government by indirect taxes on pay rolls, by taxing the people with a deficit income and continually creeping upon and reducing the income of the consuming taxpayer? One thing the Government can do, as the Scripps-Howard papers have pointed out repeatedly, is to tax the tax-free Government bonds; otherwise there is no use in raising the tax rate or the income-tax rate. We have to raise between two and three billions of dollars additional every year. If we do that we will not, by the way, exceed the proportionate tax of Great Britain or of Italy or of France or of Germany, because while the amounts paid are lower, considering the cost of living, Germany is getting approximately one-third of the nation's total income in taxes.

I think that there is no question that the Congress will tax salaries of Government employees reciprocally. We could increase income-tax rate, and the Government could provide for reciprocal taxing of salaries of Government officials.

The Federal Government has assumed already a large part of the obligations of local and State governments, and taxation of income from Government bonds which will compel wealthy people and large corporations to pay more taxes, will tend to shift the larger part of the cost of Government upon those who are best able to meet it, and will help equalize the cost of government between Federal and State and local governments.

The CHAIRMAN. Thank you, Mr. Marsh.

STATEMENT OF DAVID M. WOOD, OF THOMPSON, WOOD & HOFFMAN, MUNICIPAL BOND COUNSEL

The CHAIRMAN. We will be glad at this time to hear Mr. David M. Wood, of Thompson, Wood & Hoffman, municipal bond counsel.

Mr. WOOD. My name is David M. Wood, a member of the firm of Thompson, Wood & Hoffman, municipal bond counsel.

To understand the Constitution of the United States it is not sufficient merely to be able to read English. The constitutional guaranties of habeas corpus, trial by jury, indictment by a grand jury, due process of law, the prohibition of bills of attainder and expost facto laws, and so forth, require for their understanding a knowledge of history and of the common law. These phrases can be characterized as a sort of verbal shorthand that are unintelligible to anyone not familiar with the symbolism, and I think that every lawyer discovered that the first time he tried to explain to a client why the Constitution did not guarantee him a jury trial. And I remember one client of mine telling me the Constitution guaranteed him a jury trial and I did not know what I was talking about.

The fact of the matter is that words on a statute or the Constitution must be interpreted not by what they mean to you but to the people

who use them, and words change their meaning from time to time. For instance, you read that somebody in George Washington's time said that he was "bundling," and I think that it would be a mistake to say that he was wrapping up packages last night. The same thing is true with reference to the sixteenth amendment. You cannot interpret that amendment without knowing something of its background and some fairly intimate knowledge of the governmental structure of that amendment. So let us take a look at the governmental structure.

The United States is a sovereign itself, but it is also a federation of the sovereign States. These States acquired their sovereignty, according to the Supreme Court of the United States, on July 4, 1776, as stated in *M'Ilvaine* v. *Coxe's Lessee* (4 Cranch 209), and the first attempt at Federal organization of these States was under the Articles of Confederation, under which they declared they were sovereign and they reserved their sovereignty. When the Thirteen Sovereign States ratified the Constitution of the United States they did not surrender their sovereignty to the Federal Government but expressly created a Government with limited powers and reserved all their powers unto themselves, under the Articles of Confederation, the second article of which declared:

> Each State retains its sovereignty, freedom, and independence, and every power, jurisdiction, and right, which is not by this confederation expressly delegated to the United States, in Congress assembled.

The Supreme Court of the United States has always recognized that sovereignty, and I would here read to you a quotation of Justice Bushrod Washington, in *Worchester* v. *The State of Georgia* (6 Pet. 517), way back in the year 1832, and it is very different from the way the Federal Government interprets the relationship between the Federal Government and the States. Justice Bushrod Washington said:

> The powers exclusively given to the Federal Government are limitations upon the State authorities. But, with the exception of these limitations, the States are supreme; and their sovereignty can be no more invaded by the action of the General Government than the action of the State governments can arrest or obstruct the course of the national power.

So we have in this country a very unique phenomenon of two sovereignties operating in the same territory, and that is a system which many attribute to the survival of democracy in this country.

In order to preserve this sytem of division of powers, which the Constitution clearly intended to establish, it has been necessary for each sovereignty to so exercise its powers as not to impede the operations of the other.

As each sovereignty possesses, and must possess, the power of taxation, and as that power can be exercised to destroy the subject of the tax, the courts of neither sovereignty can exercise the power of taxation so as to impede the operations of the other sovereignty. That applies not only to the States and the Federal Government but to other instrumentalities—whatever instrumentalities they see fit to use, and these instrumentalities are not merely exempt from such taxation, but they are immune from it, because they are not within the jurisdiction of the taxing authority. The States are immune from the taxing power of the United States just as much as if they were not within the territorial limits. And so that has been applied to the taxation of public securities for the reason that the issuance of public

securities is the exercise of public power to raise revenue. Therefore the courts have held that to tax such bonds, or the income derived therefrom, is in effect to tax the exercise of a sovereign power, hence, to tax the sovereign. The burden of the tax would fall upon the issuing sovereign, but as a sovereign is not subject to the taxing jurisdiction of another sovereign, such taxation is therefore invalid.

Now, I said a moment ago that the immunity applied to every municipality. As a matter of fact, the United States Government employs private corporations through which it exercises its governmental powers, and, if it authorizes such a corporation to issue bonds in furtherance of governmental functions, the courts hold those bonds cannot be taxed by the States. The Federal land banks is a typical instance, and national banks is another. In short, every sovereign possesses the right to exercise its governmental functions through such agencies as it chooses to establish, free from the control of any other sovereign.

The purpose for which the bonds are issued is immaterial, for the Supreme Court said in *Farmer's Bank* v. *Minnesota* (232 U. S. 516) that the "issuing of municipal bonds was the performance of a governmental function within the established doctrine," and denied the contention, made in the briefs of counsel, that the purpose for which the bonds had been issued was determinative of the validity of the tax.

These rules of constitutional law were well established prior to the sixteenth amendment, and the sixteenth amendment made no change whatever in them. Prior to the amendment Congress possessed the power to tax income "from whatever source derived." There was no limitation to the taxing power prior to the sixteenth amendment, except as to the manner to be levied.

These words, therefore, "from whatever source derived," added nothing whatever to the plenary power of taxation which Congress already possessed, and you may ask why were they put in the amendment? To answer why, you have got to go back to the *Pollock case*. In the *Pollock case* the Supreme Court did not hold that the Congress had no power to levy any sort of income tax. It simply held that a certain kind of income tax was of the nature of a direct tax, and that the tax had to be apportioned in the manner required by, and in conformity with, article 1, section 9, clause 4, of the Constitution. In determining this question of direct tax the Court had to look to the source of income, and the Court did not hold that all taxes upon incomes were direct taxes but only taxes levied upon income derived from real and personal property. As to these taxes, the Court held that taxes upon income from such sources partook of the nature of direct taxes and were, therefore, subject to the constitutional rule of apportionment.

And when Congress attempted to approve such an amendment it had two things in mind: First, the necessity of avoiding the requirement of apportionment; and second, in the *Pollock case* it looked to the source of income in reaching the determination whether the tax was a direct tax or an excise tax. All the debate indicates that is all Congress had in mind, and never discussed municipal bonds prior to the time that they adopted the joint resolution; all the debate was on the necessity of avoiding apportionment, in levying an income tax.

Now, without referring to the numerous investments of the United States Steel Corporation and others, it probably occurred to someone to insert in the amendment, just as cautious lawyers are apt to do, the words "from whatever source derived" to make it clear that regardless of the source of the income, article 1, section 9, clause 4 of the Constitution was inapplicable.

Now, I think that is borne out by the history of the amendment in the Senate. Those words were added to the amendment in committee. After the committee reported it, it was adopted by the Senate, as I recall with no debate, or very little, and it was passed by both Houses of Congress with very little debate. Is it conceivable that if the Congress intended by the use of those basic words to make a revolutionary change in the amendment that there would have been no debate, and no suggestion was made that such a change was intended, and the words ordinarily had no special significance to anyone until Governor Hughes expressed the fear that these words might be construed as to subject the incomes derived from State and municipal bonds to taxation. Governor Hughes' views were immediately challenged on the floor of the Senate by Senator Brown, who introduced the amendment, and by Senators Borah, Bailey, and Root, and Senator Borah made a very lengthy speech denying that the amendment had any such intent, and Senator Borah was a leading advocate of the amendment. Senator Brown agreed with Senator Borah and Senator Root and Senator Bailey concurred with Senator Borah's views.

Now, when the administration came to read the sixteenth amendment they read it this way: "The Congress shall have power to tax incomes from whatever source derived." I can do mighty queer things with the English language that way. For instance, "All work and no play makes Jack," just by putting the period and without completing the sentence, and Senator Root realized that way back in 1918, and let me read you what he said: "If we want to consider a proposition not a part but the whole of the language must be read together."

It is very curious that Senator Root anticipated by 23 years the tactics of the present administration and the Department of Justice.

Now these words in any event are not without ambiguity. I know that the Department of Justice contends that they are absolutely free from ambiguity. It is not so. There are certain incomes which are not subject to tax under the sixteenth amendment, and even the Department of Justice would not question that. For instance, is the salary of an ambassador of a foreign country subject to tax under the sixteenth amendment? No. If Congress always possessed the power to tax incomes "from whatever source derived" why then, have the courts, both prior and since the amendment, declared that it cannot tax income derived from State and municipal bonds? The reason is that in common with all governments the United States can exercise its taxing power only over persons, property, and business subject to its jurisdiction. It is unable to tax the States and their bond issues, not because of any defect in its taxing power, but because the States are no more within its political and taxing jurisdiction than an ambassador, accredited to this country by a foreign government, is subject to such jurisdiction.

The salary of an ambassador of a foreign country, residing in the United States, is not subject to an income tax because, as the repre-

sentatives of a sovereign, he is immune from the political and taxing jurisdiction of the United States. The States being, themselves, sovereignties are, likewise, immune from the political and taxing jurisdiction of the National Government.

The representatives of foreign sovereignties are exempt from the tax jurisdiction of the United States. The States are themselves sovereign States and exempt for the same reason.

When you confer the taxing power upon the United States or upon any government, you confer upon it the power to tax persons and businesses subject to its jurisdiction and not a power to tax anything beyond its jurisdiction, and just as the salary of a foreign ambassador is beyond the jurisdiction of the United States the States and their income and bond issues are equally beyond the jurisdiction of the United States, just as the United States is beyond the jurisdiction of the States for exactly the same reason.

Now a question was asked Mr. Cohen about the distinction between the power of taxation of salaries and taxation of bonds and interest upon bonds.

While the courts, both before and since the ratification of the sixteenth amendment, have recognized the limitations which the system of dual sovereignty has imposed upon the taxing powers of the States and of the Federal Government, they have also been aware that these limitations must not be extended too far or they likewise would impair, if not destroy, the very system, the existence of which they were necessary to preserve. Both the States and the Federal Government must raise revenue, and, if the principle of immunity were carried too far, the reciprocal immunities would seriously impair the ability of each sovereign to raise revenue. The courts have, therefore, refused to apply the doctrine of taxes, which are not levied directly upon the exercise of a sovereign power, but which affect it only remotely. Thus, while Chief Justice Marshall denied the right of a State to tax the operations of a person employed by the National Government to assemble supplies for the Army, he admitted its right to tax his property.

In the very first case Chief Justice Marshall said:

> Suppose it be necessary to employ persons for the Army, would it be understood that the United States could tax the performance of any such? Of course not.

And later on when the United States established charity and religious institutions, as for military purposes, the courts held that the States could not tax those institutions. The States cannot tax the national banks without the consent of the United States but no one has ever contended employees of a national bank do not have to pay State income taxes. This distinction is brought out by two cases like *Helvering* v. *Gerhardt* (304 U. S. 405), and cases involving the taxation of bonds of governmental agencies, or the income derived therefrom. For instance, the courts have declared that a national bank is a Federal instrumentality and cannot be taxed by the States, but as I have stated no one claims that the immunity of the bank involved the immunity from taxation of the salaries of its officers. Likewise, although the Supreme Court of the United States held, in *Smith* v. *Kansas City Title & Trust Company* (255 U. S. 180), that the bonds of the Federal land banks cannot be taxed by the States, yet, when the Supreme Court of Mississippi in *Parker* v. *The Mississippi State Tax Commission* (178 Mississippi 680), sustained a State tax

upon the salary of the vice president of the Federal Land Bank of New Orleans, the Supreme Court refused to review that decision (302 U. S. 742). In short the power to tax the income, or property of a person employed by a governmental agency and the power to tax the agency itself or its operations, rest upon entirely different principles.

Now here the Supreme Court of the United States did not consent to that taxation of the vice president of the Land Bank of New Orleans.

The CHAIRMAN. Is it correct that the Federal land banks are agencies of the Federal Government?

Mr. WOOD. They are agencies of the United States Government, and that was so held in that cause. That distinction has always been recognized and was not opposed by the decision in the *Gerhardt case*. How far that case goes, I do not know. I am prepared to say on the other hand certain employees of the States or subagencies may be subject to that taxation. On the other hand I do not know just where to draw the line of distinction. It will probably take years of legislation and decisions of the courts to reach a conclusion as to that.

There is one other point that I would like to make and that is to call your attention to some of the significance of the interpretation of the sixteenth amendment advocated by the Department of Justice, that this sixteenth amendment was a new grant of power and it is not subject to the other limitations contained in the Constitution, such as the inability of the Government to tax income from State and municipal bonds, etc. Well, now, if that is so, it has some very peculiar significance. If the sixteenth amendment is a new grant of power, then it authorizes the levy of a direct tax without being subject to the limitation of apportionment, and we give the Congress the power to tax the income of our Federal judges, although the Supreme Court said the Congress cannot reduce the salary of the judge during his term of office. Many other limitations in the Constitution would be wiped out by their interpretation of the amendment. I do not know how many, but there are many of them. For instance if you follow their interpretation, the Congress can tax the income of the States and of the municipal corporations because under their theory of the meaning of the amendment the States and municipalities have incomes and they are subject to the tax, and as a matter of fact the briefs assert their right to tax the authorities, and as I read the White Book they assert the right to tax the revenues of the State and municipalities.

The CHAIRMAN. This proposal to tax the securities of the State is not direct. It is indirect.

Mr. WOOD. I think that it is direct.

The CHAIRMAN. Well, they do not propose to tax the income of the States and issues of the State bonds. They propose to tax the income from those bonds when received by individuals and corporations, and that is the opinion I have, and when I say that it is direct and not indirect, that is, so far as the individual is concerned. It probably is indirect upon the State in causing its bonds to be issued at a higher rate of interest to protect the public, but I do not find when I have read the so-called White Book that it is the opinion on the part of the Government that it may tax the State itself.

Mr. WOOD. Well, Senator, the best evidence of intention of anyone is what he actually does. Now, the United States in a certain case

of one State attempted to assess taxes upon the issue of bonds of Maine; later on they reversed that ruling, but they did try to collect taxes on the Delaware Bridge bonds, and they tried to tax the port authority, and I do not think the Treasury Department and the Department of Justice attempted to tax them, but they are actually attempting to levy such a tax right now.

I do not think insofar as bonds are concerned it is a direct tax, but it is true that it is paid to the Government, but you tax the purchaser of the bond, and the fact that somebody else pays it is immaterial.

The CHAIRMAN. When you charge a municipality $1,000 for giving advice as to the floating of the bond issue, and you pay an income tax on that $1,000 to the Federal Government, do you think the Federal Government has taxed the municipality?

Mr. WOOD. No. That is a very remote tax. The courts have held that the tax on the income is a tax on the bond itself in the very first decision, and the Supreme Court said that was income tax, and the Supreme Court in the case of *Weston* v. *Charleston* said that it was a levying of a tax upon the net interest received by the taxpayer, and he was required to lose all the interest he received on the investment, and the Court said that so far as that amounts to a tax upon interest derived from such source it was unconstitutional, and held when you levy a tax directly.

Now when a transaction such as you have in mind occurs, the tax is very remote because the tax is on my net income.

The CHAIRMAN. Isn't that identical?

Mr. WOOD. No, sir.

The CHAIRMAN. But suppose that a man held $10,000 of municipal bonds and the return was $250, and the man's income other than that was fifteen hundred dollars, and he would not pay a tax on it?

Mr. WOOD. But the municipality issued the bond, and I do not think it is a question of whether the money goes to the owner, for the Constitution covers that, and the question is: Did it burden the municipality, regardless of where it went? If it put a burden on the municipality then it is unconstitutional. Now the courts have distinguished such cases as you have in mind, for instance, tax upon interstate commerce. If you levy a tax on the gross income derived in interstate commerce, that is unconstitutional, because that is a burden on commerce.

The reciprocal immunity from taxation of the United States, the States, and of their instrumentalities of government has been recognized by the Supreme Court for generations. In every decision rendered, construing the sixteenth amendment, the Supreme Court has held that it did not extend the taxing power of Congress to new or previously excepted subjects. In short, the Court has recognized it for what it is—an amendment to an existing Constitution which must be construed as a part of that document and in harmony with all of its provisions. The Court has never made an unjustifiable assumption that merely because, in an amendment relating to taxation, is to be found the obscure phrase "from whatever source derived," the people intended to abandon the fundamental concept upon which the Federal Government is based, and to establish, in place of "an indestructible Union of indestructible States" a highly centralized National Government.

STATEMENT OF CARROLL S. BUCHER, SECRETARY, CALIFORNIA STATE COMPENSATION FUND

Mr. BUCHER. I am chief counsel of the State Compensation Insurance Fund of the State of California. I will speak very briefly and extemporaneously, and in speaking of this I may state that I also represent not only our State compensation fund, and for brevity hereafter I will speak of it as the State fund but also 16 other State funds operating the business of workmen's compensation insurance in this country. The argument which I will present in opposition to a tax upon governmental securities applies to the funds of other States as well as those of California. Twenty-five years ago, the people of our State having decided that they desired the benefit of social legislation known as the workmen's compensation insurance system, amended its constitution to enable its legislature to enact laws to put such a system into effect. And I want to speak upon the effect we believe this proposed legislation will have directly upon the State funds, and indirectly upon the system of workmen's compensation insurance system and upon injured employees.

California was one of the first States to enact the workmen's compensation insurance system, and I may be allowed to say that our Compensation Act has been copied by over half of the States that now maintain workmen's compensation.

The CHAIRMAN. When was that? What year was that?

Mr. BUCHER. 1913.

The CHAIRMAN. We passed ours in 1911.

Mr. BUCHER. I know that there are four States ahead of us. Under our law it is mandatory that every employer carry a policy in some insurance company or in the State fund directing him to obtain a certificate to allow him to insure, and he must protect his employees. Under our law also the State fund must insure every employer who seeks a policy, large or small, based upon the hazards of the employment. That does not apply to the common carriers.

The result of that is that the State fund is burdened with large amounts of small and hazardous employers who cannot secure certificates of insurance because of their assets.

Without the large risks no State fund can survive because the large risk is the profitable risk to a State fund. It is the same as the long and short hauls in the railroad system. Without the short haul the railroad company is prejudiced, so we must maintain the State fund in its relationship to the larger employers to survive. As stated by Mr. Justice Shaw in passing on the constitutionality of the State fund, if the State fund does not exist in California there is no place for the small employer, and he cannot obtain his insurance to protect his injured employees.

Now, what is the effect of this on the fund? The competition between the State fund and the private insurer is so keen that we must maintain 2 percent of dividends on it to our insurance owners. If we cut down and reduce our dividend as much as 2 percent then we are left holding the stock.

The CHAIRMAN. You are not now subject to income tax so far as the Government is concerned.

Mr. BUCHER. No, sir.

The CHAIRMAN. And California has a State income-tax law?

Mr. MUCHER. Yes

The CHAIRMAN. So your concern is taxation of municipal bonds and securities?

Mr. BUCHER. Yes; all our assets must be invested in what are called tax-exempt securities, because we can invest only in those securities. Taking the year 1938 as an example, we owned approximately $14,000,000 in tax-exempt securities.

The CHAIRMAN. I just wanted to get it clear that the proposal of the Government would not reach your income at the present time.

Mr. BUCHER. I fear that it would affect our income upon our tax-exempt securities, which we own. On the basis of $15,000,000—I may not be correct, Senator Brown, but we would be subject to a direct tax of $75,000 a year, and on top of that, if the Congress should provide for such tax, and if not this Congress then another Congress might provide for tax on our income which would not only impair our integrity but completely involve the State fund, because in the event we have to pay a tax upon our net income, not only income from tax-free securities, we would have to pay a tax of $75,000 to $550,000 per year, and for that reason, and for the effect that it would have upon the fundamental principles of the Workmen's Compensation Act, 6,000,000 wage earners in California would be very seriously affected.

The CHAIRMAN. There is no proposal to extend the taxing power to State corporations, and so on, in this proposal?

Mr. BUCHER. No; that is right.

The CHAIRMAN. That is my understanding, and I want to make that clear. Of course, it is possible in the future that may be done, so your argument is sound, but I do not think that there is any present intention to tax such institutions.

Mr. BUCHER. And just one last thought: If the State fund is prejudiced, if it is interpreted as taxing such institution, the wage earners of California and of all the other 16 States maintaining State funds will suffer.

Now, with that remark, I will submit my written statement to the committee.

Twenty-five years ago the people of our State, having decided that they desired the benefit of social legislation known as the workmen's compensation insurance system, amended its constitution to enable its legislature to enact laws to put such a system into effect. At that time workmen's compensation laws were believed to be ultrasocialistic and radical and were opposed by employers generally. During the years following such legislation, workmen's compensation has become so beneficial, not only to the employee but to the employer, that there are now few employers who will admit that this system is other than a conservative one and that industry is benefited equally as well as labor.

By the amendment to the constitution, our legislature was instructed not only to provide for a complete system of workmen's compensation but was specifically instructed to create the State compensation insurance fund, and in compliance with this mandate such fund was established.

The Workmen's Compensation Act is founded upon the theory of insurance and that the cost of providing for industrial accidents should be borne by the industry causing such accidents. Its cost is a tax upon the industry, which is then added to the cost of production and

eventually distributed among the people. The passage of a compensation act without a provision for State insurance would have so completely demoralized business in California that our courts would, without hesitation, have declared the law unconstitutional if the legislature had not at the same time created a State fund and established a system whereby employers could protect themselves by insurance.

The fund is therefore a governmental agency of the State created for the purpose of collecting and distributing compensation imposed upon the industries and without profit to itself or the State.

Employers in California are compelled by law to carry insurance, and a failure to do so is a crime. No employer may conduct business unless he carries insurance, and unless he is able to obtain it, he cannot fulfill the requirements of the law. Thousands of employers carry insurance with the State fund who cannot obtain insurance elsewhere. This is because of either bad experience of those employers or extra or unusual hazards surrounding their industries. Under the California law, the State fund is obliged to write compensation insurance for every employer who seeks it, upon the payment of the required premium. Small farmers, hazardous enterprises—such as mines, window washers, steeplejacks, and others—are able to fulfill the requirements of the law only because the State fund is in existence.

The fund is in open competition with private carriers but operates without profit. The excess between administrative cost and losses, on the one hand, and the premiums, on the other hand, is returned to the employer-policyholder in dividends. The competition between the State fund and the private carrier is so keen that unless the present divident-payment scale is maintained, the larger and better classes of risks will desert the State fund and insure with the private carrier. This will seriously impair the integrity of the State fund, because it cannot successfully write business alone for the small or the extra-hazardous employer for the premium rates established by the State, and if the State fund should fail, the small employer will be left without insurance and his employees will be unprotected, according to the solvency of the employers.

Because the State fund is a State institution as distinguished from a private carrier of insurance, it is admitted that it can be, and is, more liberal in the settlement of its claims, and because of the State fund being in competition with the private carriers, and its liberal policy, the private carrier is, of necessity, more liberal in the payment of its claims. If the State fund should retire from business, the injured employees would suffer by a more restricted policy of claims adjustments. The State fund was not organized to put the private companies out of business, but to assure the employers of California that an agency existed that was required to write their business regardless of the type of the hazard surrounding it.

It is therefore necessary for the protection of the wage earner that the integrity of the State fund must be preserved.

During the year 1938, the State fund of California owned tax-exempt securities of the par value of $14,719,000 upon which it received interest in the sum of $450,044. A tax based upon this income alone would amount to $74,250. A tax upon other net income of the State fund would amount to $550,000, making a total of $624,250 annually. These taxes would be deducted from the dividends paid

to our policyholders. If this deduction should be made, it cannot be disputed that the "cream" of the State compensation insurance business in California would leave the State fund and insure with the private carriers. The competition is so keen that a reduction of the normal annual dividend rate of 2 percent is sufficient to drive the larger policyholder away from the fund.

The State fund does an annual gross premium business of $11,000,000. The total dividend disbursed in 1938 upon the 1937 business amounted to $3,220,000. Therefore, if we should be charged with a tax upon the incomes of our tax-exempt securities—and all of our securities are tax exempt, because we can only invest in such classes of securities—such tax would be deducted from our dividends, the favored and profitable risks would leave the State fund for private carriers, the fund would be left with the nonprofit and extra-hazardous risks with which it could not survive, and it would eventually be forced to retire. Such a condition would result in chaos in industry in California, depriving the injured employees of the compensation benefits to which they have become accustomed during the past 25 years.

It is, therefore, with the utmost conviction we urge upon your committee to give full consideration to the effect the imposition of a tax upon such securities would have upon the State funds in this country and the indirect effect it would have upon the millions of employees who rely upon workmen's compensation insurance for their maintenance in the event of injuries causing disabilities.

STATEMENT OF R. GRANVILLE CURRY, REPRESENTING ALBANY PORT DISTRICT COMMISSION

Mr. CURRY. May it please the committee: My name is R. Granville Curry, and I am a member of the law firm of Curry & Dolan, Washington, D. C., and I appear on behalf of the Albany Port District Commission of Albany, N. Y., to urge three points. In arguing this matter, I wish to deal more with the practical side of the question rather than the legal phase which has been argued so ably here before the committee.

(1) That Congress do not undertake to tax the income from bonds issued or to be issued by a State or an instrumentality thereof, such as the Albany Port District Commission.

(2) That Congress do not undertake to tax the income of State employees or employees of State agencies, including this Commission, and

(3) That in any event before attempting to enact Federal laws providing for such taxes there should first be obtained an amendment to the Constitution ratified by the States in the manner provided in the Constitution, authorizing such legislation.

The Albany Port District Commission was created as a State agency under the laws of the State of New York in 1925, to provide, develop, and maintain port and terminal facilities at Albany and Rensselaer on the Hudson River, following careful surveys made by the War Department and an act of Congress making provision for deeping the Hudson River and the reestablishment of the deepwater port at Albany (Rivers and Harbors Act of March 3, 1925). The

Federal project was subject to the condition that this State agency would be created to provide appropriate port facilities.

Pursuant to such legislation the Federal Government has spent over $5,080,000 in deepening the Hudson River to and from the port of Albany, thus making it available to ocean-going vessels; and the Albany Port District Commission, as an agency of the State of New York, has spent over $7,780,000 in providing a modern and efficient port.

In order to provide funds to carry out the purposes for which the Albany Port District Commission was created, the Albany port district was established as a taxing area embracing the cities of Albany and Rensselaer. Under this legislation bonds issued by the Commission are a lien upon the real estate within those two cities.

Acting under authority of the State laws, the Albany Port District Commission in the development of the port of Albany has issued $7,836,000 of bonds of which as of January 1, 1939, $7,107,000 were outstanding. This compares with the assessed valuation of real estate in Albany and Rensselaer of approximately $248,000,000. Budget requirements of these cities to provide for interest on funded debt and bond retirements amounted to approximately $277,000 for the year 1938.

While there appears to be no proposal to tax income from any State bonds which have already been issued, a position which seems fair and equitable, yet any provision for taxing the income on future bonds of the Albany Port District Commission would impose unjust burdens upon this State agency and the taxpayers supporting it, and this, it is respectfully submitted, would be in contravention of the Constitution. The imposition of a tax on new bonds of the commission would undoubtedly raise interest rates and render the bonds less attractive. The effect would be added costs, which would increase the net deficiency of the commission each year and the two cities would be called upon to raise the money. Real estate is already overburdened. With present taxes and a recent recommendation by the Governor of New York for an additional tax of $1 per thousand on real estate, property owners are becoming more and more dissatisfied with the increasing tax burden upon their properties. Even now the burden is almost unbearable particularly for owners who have only small incomes in wages or salaries.

The Albany Port District Commission believes that to impose taxes upon the income of its bonds would be an unconstitutional invasion of State authority contrary to principles repeatedly recognized by the Supreme Court of the United States and accepted as inherent in our form of government. The authorities in support of the position of the States have been presented in detail by the attorneys general of the States and need not be repeated here. They are convincing that Federal legislation is not justified and that in fairness so serious an invasion of State rights should not be attempted without obtaining in the appropriate manner and after full discussion and consideration by the States an amendment to the Constitution specifically providing for Federal taxation of State agencies and the income from bonds thereof.

The Albany Port District Commission also respectfully submits that State employees such as those of the commission should not be

subject to the additional burden of Federal taxation. Generally speaking their salaries are low, promotion is extremely slow, and their tenure of office uncertain.

On behalf of the Albany Port District Commission, I wish to express appreciation for this opportunity to set forth its position in this proceeding.

STATEMENT OF DANA B. VAN DUSEN, GENERAL COUNSEL OF THE METROPOLITAN UTILITIES DISTRICT OF OMAHA

Mr. VAN DUSEN. Mr. Chairman and gentlemen of the committee: I wish to endorse everything that is said in the brief on the Constitutional immunity of States and municipal securities defending the continued integrity of the fiscal power of the States, because in this problem our governmental agency has the same interest as the States themselves. However, I wish to relate my remarks directly to the public service which I represent.

The Metropolitan Utilities District of Omaha is an agency created by the State for the primary purpose of operating and managing all public utilities acquired by the city of Omaha, with the added power of giving service throughout the State, as conditions and their judgment indicate is beneficial. The board is nonpartisan—it consists of three Republicans and three Democrats. We are the managers of water and gas properties, the legal title to which resides in the city of Omaha, and which properties were acquired by the exercise of the power of condemnation of the city, and paid for by the issuance of city bonds, combining the features of a pledge of revenue and also the pledge of the general taxing power.

The city of Omaha is a home-rule city, and as such may be described as an independent sovereignty, able to confer upon itself, and to exercise, all powers except those which may be prohibited by the constitution or general laws of the State. This power of home rule is an expression of the desire for, and the desirability of local self-government, which permits the citizens of Omaha to deal with governmental and economic problems in the light of peculiar local conditions. Because of local conditions, as well as a belief in the desirability of municipal ownership of essential services, the late United States Senator Robert B. Howell championed the movement by which these two utility properties were acquired, and became the first manager of the district. In the supply of water we are, of course, a monopoly, while in the supply of gas we are in competition with other fuels and in increasing competition from electric energy.

In our own State we have been declared by our supreme court to be exempt from all taxation. This exemption, of course, does not extend to the Federal income tax on employees, as to which the utilities district has no objection, provided it is not retroactive. However, our general exemption from taxation was one of the inducements which led to the acquisition of these properties because it permitted their acquisition at a lower initial cost, permitted their operation at lower cost, and has made it possible to give the masses of people service in the necessities of modern life at a cost much lower than previously they had been compelled to pay.

In the operation of these properties the effort has been devoted to giving service to the entire population at the lowest possible rate consistent with accumulating adequate funds to pay off the purchase bonds. Because the rates for water and gas have been reduced to the lowest possible level, it would be difficult, perhaps impossible, to pay off these bonds at maturity if the slightest financial burden is added through any form of taxation. If that burden is added, it will then become necessary to seek from the legislature the power to issue refunding bonds, a power which is not at present available, and which might not be obtained from the legislature in time to avoid difficulty. Any immediate taxation would therefore present an immediate pressing problem endangering the stability of this publicly owned institution and complicating its future.

In viewing the effect of proposed legislation upon a utility such as ours, the fact that our outstanding bonds have been largely amortized or retired, is a mere incident which does not affect principles. If income from the present bonds is taxed, it would seem that the burden would fall on the individual owners; but in the event of any new issue, though the tax would be collected from the holders, it would in reality be paid by the district—in the form of an increased interest rate. Therefore, we view the situation the same as if we were now about to acquire our existing properties and issue bonds in payment therefor.

If the utilities district is permitted to continue without the added burden of taxation, it will pay off its bonds at maturity, and then being entirely free from debt, with no dividends to pay to stockholders, it will be able to give service to the people at a cost unprecedently low, which is considered the most desirable objective. On the other hand, since the district automatically becomes the operator of any public utility acquired by the city government, it would be possible to use the revenues of the district to finance any publicly owned service enterprises, or generally to assist the public in improving the community for the benefit of all citizens alike.

The advantage derived by the utilities district by its exemption from taxation is not an advantage peculiar to it in its corporate capacity, but quite to the contrary is passed on to the mass of the people. This is necessarily true since the service which we render is available to and made use of by almost 100 percent of the population. The freedom from taxation makes available to these people an essential service at the lowest cost, thus lifting a part of the cost of Government from the shoulders of those least able to bear the burden of taxation, which all American theories agree should be placed upon the shoulders of those best able to bear the burden.

Taxation has no limit whatever, and is, of course, the power to destroy; any proposal to subject these properties to taxation endangers the success of the policy of essential service at the lowest possible cost, and also endangers the possibility of acquiring new properties for the purpose of similar services which have become or are becoming essentials of modern American life. The freedom to solve the local problems of the municipality and adjacent municipalities will be restricted, and very probably to the detriment of the citizens concerned.

We feel that any first step on the road to the taxation of these enterprises is one which will inevitably be followed by further steps, until finally every possible form of taxation will be imposed upon these properties. Beyond all question any taxation imposed upon these services must inevitably result in an immediate increase in rates, and this increase in rates will result in hardship to those least favorably situated economically and, of course, will result in great dissatisfaction. Furthermore, any increase in rates must necessarily result in an advantage to the privately owned electric utility which supplies the source of energy, as fuel, in competition with gas, and any advantage given to this competition must necessarily result in a diminution in the value of the competitive properties already acquired by public funds and devoted solely to the public benefit. Indeed, the imposition of any tax burden will be everywhere throughout the United States a serious blow to municipal ownership, which, if it has no other merit, and it does, is a constant threat to any overly avaricious private public service.

It seems to the metropolitan utilities district of Omaha that there may well exist a distinction between the desirability of tax exemption in the case of necessary mass public service and those enterprises undertaken by the authority of the States which do not concern common living needs. Therefore, it seems to us that any indiscriminate policy of taxing all activities, whether of the Federal Government or of the States and their agencies, is unwise, and ignores important differences which should be given consideration. In this we believe our own situation is distinctive and requires separate consideration. Even assuming that an unrestricted policy of tax immunity for public enterprises is open to question, the fact remains that the problem of distinguishing between those services which are fundamental and those which are merely convenient, the problem of how far any such tax program should go, is delicate, far-reaching, and requires judicious study. It is not true that the destruction of all tax immunities of this character is necessarily a benefit to the mass of the people and it is their benefit which would be the objective of any such program.

The CHAIRMAN. I have a telegram from the Governor of Maryland, Herbert R. O'Conor, which should be incorporated into the record:

Senator PRENTISS M. BROWN,
Chairman Special Committee on Taxation of Governmental Securities,
Senate Office Building, Washington, D. C.:

Permit me to register State's opposition to Federal taxation of Maryland securities as well as securities of State governmental units for two-fold reason that such impost would adversely affect quotation of State, county, and municipal securities without corresponding benefit to National Government and because such impost is contrary to the fundamental separation of State and Federal sovereignty. Kindly record this expression before your committee and favor us by making our opposition known to other members.

HERBERT R. O'CONOR,
Governor of Maryland.

The CHAIRMAN. I also have a telegram from the Governor of the State of Washington, Clarence D. Martin, which I wish to incorporate into the record:

Hon. PRENTISS BROWN,
United States Senator, Senate Office Building,
Washington, D. C.:

Re Federal tax on State and municipal bonds: Federal taxation of State and municipal bonds has recently been considered by our State finance committee. It is the considered opinion of our committee that such legislation would not be beneficial to majority of people in this or any other State. Such a tax would result in coupon rates of interest being increased sufficiently to cover tax in higher brackets. Burden of increased interest rates would fall on average taxpayer and leave bondholder in same net position now held. Request you place State of Washington before your Committee on Intergovernmental Taxation as opposed to Federal tax on State and municipal bonds.

CLARENCE D. MARTIN,
Governor, State of Washington.

(The following letter was later received and ordered to be printed in the record:)

CONFERENCE ON STATE DEFENSE,
New York, N. Y., February 27, 1939.

Hon. PRENTISS M. BROWN,
Chairman, Special Committee on Taxation of Governmental Securities and Salaries,
United States Senate, Washington, D. C.

DEAR SENATOR: It has just this moment come to my attention that there appears on pages 312-315 (pt. 2) of the printed record of the hearings before the Special Committee on Taxation of Governmental Securities and Salaries, a proposed report from the Committee on Taxation of the Chamber of Commerce of the State of New York over the signature of the chairman of that committee.

No action was taken by the Chamber of Commerce on the basis of this report, and I understand that the matter is still pending before the executive committee of the chamber. The proposed report of their committee on taxation was not intended to be a public document and its presence in my files and subsequent inclusion in the list of resolutions offered to your committee was an inadvertance, for which we must apologize both to your committee and to the chamber.

As you know, we have requested the deletion of the proposed report from the record, but the advanced status of the work being done in the Printing Office makes this impossible.

I therefore respectfully request that you include this letter as a part of the record.

Respectfully yours,

AUSTIN J. TOBIN, *Executive Secretary.*

The CHAIRMAN. We will now recess until Tuesday morning at 10 a. m.

(Thereupon at 12:40 p. m., a recess was taken by the committee to Tuesday morning, February 14, 1939, at 10 a. m.)

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