TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

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BEFORE THE

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TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

TUESDAY, FEBRUARY 14, 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 be in order.

We will first hear from Prof. Kossuth M. Williamson, of Wesleyan University, of Middletown, Conn.

Professor Williamson.

STATEMENT OF KOSSUTH M. WILLIAMSON, PROFESSOR, WESLEYAN UNIVERSITY, MIDDLETOWN, CONN.

Mr. WILLIAMSON. I have a very short statement or memorandum, which I would like to read to your committee, and then, if there are any questions following, I will be very pleased to answer them to the best of my ability.

The CHAIRMAN. Certainly.

Mr. WILLIAMSON. I assure you that it is not very long, but that it is a brief statement on the proposal to eliminate the reciprocal exemption of future issues of Federal, State, and local government securities and of salaries of employees of these agencies and is not intended to be exhaustive.

Since such matters lie outside of my sphere of competence as a tax economist, I shall say nothing about the constitutional aspects or the relative merits of procedure by statute or constitutional amendment. Nor shall I present any statistical material, leaving that to the statisticians and others who have made independent investigations of this character.

TAXATION OF GOVERNMENT SECURITIES

I shall now take up the subject of taxation of Government securities.

Perhaps I could be of most service if I give you my reactions to the most important issues in the current debate upon this proposal. These issues are:

(1) The effects of tax-exemption upon the principle of progression in taxation;

(2) The economic effects of tax-exemption; and

(3) The revenue results of abolition of tax-exemption upon future issues of Government securities.

It will be noted that, since action with respect to existing issues does not seem feasible or equitable, my remarks relate only to the elimination of the tax-exempt privilege for future issues.

EFFECTS OF TAX-EXEMPT SECURITIES UPON THE PRINCIPLE OF PROGRESSIVE TAXATION

One of the most crucial arguments against tax-exemption of Government securities is that it obstructs the effectiveness of the progressive income tax. It is important that the theoretical validity of this contention should be understood. Such a result arises because individuals in the higher income brackets gain more in surtaxes avoided than they lose on the lower interest rates of tax-exempt bonds.

If the volume of tax-exempt securities were so limited that the supply would be entirely absorbed by those to whom exemption was most valuable, the wealthy investors in a freely competitive market would tend to force the bond yields down to the point where at least some of the wealthy investors would be losing as much in reduced interest as they gained in tax reduction.

When, however, the supply of bonds issued is so large that they must be purchased by lower-income individuals, by corporations, and by tax-free institutions, the price of the bonds must be low enough, or the interest rates high enough, to attract these purchasers to whom the value of the tax-exemption is much less.

Buying in the general market, the wealthy investors do not have to pay any more for the tax-exemption privilege than it is worth to buyers who would not have to pay high surtaxes anyhow. These wealthy investors gain, therefore, more than they lose.

Their profit is measured by the spread between the interest they lose and the taxes they save. Under such conditions, tax-exemption of the bonds does offer the opportunity to the wealthy to escape the burden of the higher surtaxes. Factual studies bear this out. They leave no doubt that tax-exemption impairs the effectiveness of the progressive principle.

The significance of this weakening of the effectiveness of progression depends in part upon the validity of the policy of progression itself, and upon the fairness or desirability of the present high levels of the surtaxes. There are, of course, various objectives in progressive taxation. One objective is to achieve equity in the distribution of the tax burden; another is to decrease the inequality of incomes.

Whatever the objectives may be, it must be recognized as a fact that the country is, in our times, committed to the policy of progression. Although the question of what surtax rates are expedient or fair may well be moot, the validity of the policy of progression is no longer debatable. Tax-exemption, therefore, by offering escape to the wealthy from burdens legislated upon them by statute. obstructs the operation of this established policy and creates a socially undesirable situation.

Moreover, it is not in the interest of democratic institutions to allow conditions to exist which prevent the enforcement and effectiveness of legislative intent. Democracy does not profit from the procedure of enacting policies without implementing them. If the scale of rates of our surtax is thought to be unfair or unsound economically, it is more fair, and more sound economically, for the Government itself to revise them, rather than for wealthy individuals, through the legal loophole of tax-exemption, to accomplish a hit-or-miss revision of their own.

The CHAIRMAN. Will you please read that again?

Mr. WILLIAMSON. Moreover, it is not in the interest of democratic institutions to allow conditions to exist which prevent the enforcement and effectiveness of legislative intent. Democracy does not profit from the procedure of enacting policies without implementing them. If the scale of rates of our surtax is thought to be unfair or unsound economically, it is more fair, and more sound economically, for the Government itself to revise them, rather than for wealthy individuals, through the legal loophole of tax-exemption, to accomplish a hit-or-miss revision of their own.

But some may contend that, whatever the theoretical possibilities, the factual evidence does not indicate that the rich are availing themselves of the opportunity to escape from the progressive burdens of the surtaxes.

The CHAIRMAN. You are not, yourself, saying that is a fact?

Mr. WILLIAMSON. No; and I am going to comment on that now.

Sample studies have been made of the composition of estates probated in recent years and estimates have been made by the Treasury Department and others as to distribution of the ownership of the existing tax-exempt securities. These studies suggest that there has been no great flight by the rich from other investments to tax-exempt securities, and that, in fact, the bulk of these securities are held by governments, institutions, corporations, banks, and insurance companies, not subject to the surtax. Almost all of the increase of governmental debt of recent years has, according to the Twentieth Century Fund, been taken up by credit institutions.

The statistics I do not go into, because, undoubtedly, they are available to the committee.

The data underlying all these studies are, of course, incomplete and subject to wide margins of error.

Moreover, the studies mentioned are not up to date, and do not preclude the statistical possibility that a change has occurred in the last 3 or 4 years and that there may actually exist a more definite trend to tax-exempt securities on the part of the wealthy at the present time.

But even supposing the studies to be entirely accurate, and to reflect current conditions, the obstacle of tax-exemption to progressive taxation is still serious. The seriousness derives from the fact that the holdings of individuals, though not a disproportionately large percentage of the outstanding securities, nevertheless in absolute terms constitute a very large sum, indicating that many taxpayers do avail themselves of the tax-exempt privilege.

Reinforcing this is the fact that the larger the investors, the higher, according to the evidence, the percentage of their fortunes held in tax-exempts, demonstrating that the greater importance of tax-exemption to wealthy investors than to investors of limited means is well appreciated.

Thus, though the statistics, such as they are, may minimize the loss of revenue from tax-exemption, they do not disprove the proposition that tax-exemption undermines the progressive feature of the income tax to a marked extent.

Not only do tax-exempt securities impair the effectiveness of progression: They tend, in addition, to burden less well-to-do investors. The competition of the wealthy to buy securities for tax-exemption purposes raises bond prices and lowers bond yields. Individual investors of small means, savings banks, and life insurance companies must necessarily accept somewhat lower interest rates on Government securities than would be enjoyed if the prices of such securities were not, to some extent, inflated by the demand of wealthy taxpayers seeking escape from surtaxes.

Thus, poorer investors, savings bank depositors, and life insurance policyholders bear, in the loss of interest, a sort of indirect taxation. It is they who help to make up part of the Government's loss in revenue from tax exemption.

A strong case, then, for the elimination of the privilege, can be made, not only from the fact that tax-exemption obstructs apparent legislative tax policy, but also from the fact that it tends to distort the distribution of the burden of taxation.

THE ECONOMIC ARGUMENT

Some proponents, however, of the elimination of tax-exempt securities for the future, urge it also on economic grounds. They contend that tax-exemption distorts the capital market and diverts the investments of the wealthy, who can best afford to take risks, away from equities.

The discontinuance of tax exemption, according to this view, would force funds out of bonds back into enterprise and risk-taking, and would in this way greatly stimulate the revival of the capital market. For several reasons it is probably wise not to base the case for the proposal on such economic considerations.

In the first place, the discontinuance would apply only to future issues, and such economic consequences upon investment behavior would, if they resulted at all, be long delayed.

In the second place, though the volume of tax-exempt holdings is large, the influence of tax-exemption upon the decline of the aggregate volume of private investment in recent years is uncertain. Competent economists are by no means in agreement as to the causes of the decline.

Moreover, we have already pointed out that such data for the past as are available do not reveal any definitely increasing shift of the wealthy to tax-exempts.

Of course, there is the possibility, already mentioned, that the incomplete and lagging statistics do not report a more decided trend that may well be going on now in that direction.

If, however, the investment behavior of the rich does not ultimately prove to have been exceptionally partial to tax-exempt securities recently, the explanation of the decline in private investment and of the shift in the ownership of equities will have to be sought elsewhere.

Other factors may be quantitatively more responsible for the present distress of the private capital market than any increasing influence of tax-exemption upon the investment stream of surtax payers. So complex and far reaching are the causes for the timidity of private investment and the stagnation of capital-goods industries that it would be a dangerous oversimplification to attach great significance to the influence of tax-exemption upon the aggregate investment situation. It is much safer, therefore, to base the case for discontinuance of tax-exemption upon the sufficient and more certain grounds of tax equity and the principle of progression.

However, this much can fairly be said. If the tax-exemption feature has any economic effects at all, the presumption is that it would discourage private investment.

In addition to securing the advantage of equity and fairness, the discontinuance of tax-exemption will forestall future discrimination in tax burden upon the income of enterprisers and risk-takers as compared with that of the Government bondholder, and, insofar as such discrimination is an unfavorable economic influence upon aggregate investment, will yield an important economic result as a by-product.

THE FISCAL ARGUMENT

I now turn to the revenue argument advanced against this proposal. According to newspaper references, Professor Lutz has presented estimates to show that the change will not result in any great net gain in the budget position of the Federal Government after the deduction has been made for higher interest that will have to be paid on future bond issues.

On the other hand, he contends that the change would produce a substantial future net loss to the State and local governments, resulting thus in an actual budgetary loss to all levels of government taken together.

It is interesting to note that Prof. C. O. Hardy, a little over a decade ago, arrived at somewhat similar, though not identical, estimates of the probable fiscal results of ending tax-exemption.

Such estimates are, of course, subject to wide margins of error, because they relate to unknown future conditions, and must be based upon uncertain assumptions.

Even if we accept the Lutz estimates, however, they do not constitute a compelling argument against the advisability of discontinuance of tax-exemption. So far as the Federal Government is concerned, as the Under Secretary of the Treasury has pointed out, the change would still be desirable on grounds of equity and the strengthening of the progressive feature, even if the change resulted in a net loss.

Any plan of tax revision aimed to redistribute the burden of taxation necessitates the reduction or elimination of some taxes and the replacement of the lost revenue by new, more equitably obtained receipts. The mere pursuit of revenue productivity, without consideration of the adjustment of the burden, ignores tax justice.

From the point of view of securing the adoption of the proposal, however, the contention that the State and local governments will suffer a net loss from the change is a highly important matter. The expectation of loss arises from the fact that these governments have been enjoying an indirect subsidy in lowered interest on their bonds. The subsidiary governments do not wish to surrender this advantage and thus to suffer additions to their future interest costs. If the proposal is to win their support, therefore, it will doubtless be necessary for the Federal Government to compensate them for this injury to their vested interests in the tax-exempt privilege. If the problem is considered sufficiently important, however, a satisfactory solution can probably be found.

The ideal plan would be to work out a solution of the much larger question of Federal-State tax conflicts in general, of which reciprocal immunity of governmental securities forms only a part. This larger problem of intergovernmental fiscal relations has been growing increasingly serious in recent years.

On the other hand, it is a question whether any unified and thoroughgoing plan of coordination of these fiscal relations can be achieved by political procedures.

Perhaps progress in this direction will have to be made piecemeal and by compromise as the most pressing problems arise. If that view is correct, the elimination of tax-exempt securities may unfortunately have to be handled individually as one of these piecemeal solutions.

In default of any such solution of the tax-exemption problem through a thoroughgoing coordination of the intergovernmental fiscal relations in general, the Federal Government might agree to pay the States an outright subsidy for a limited number of years to reimburse them for the fiscal loss from the discontinuance of the tax-exempt privilege. This suggestion has been made by other students of the problem, and if the proposal cannot be carried through otherwise, it seems worthy of serious consideration. The elimination of evasion, the gain in equity, and the strengthening of the progressive feature of the tax system should be well worth the cost.

THE TAXATION OF GOVERNMENT SALARIES

The elimination of the reciprocal tax immunity of government salaries is also justified by considerations of sound tax principles. If we are to set as one of our goals in taxation the best possible adjustment of the tax burden in accordance with the ability to pay or the economic status of individuals, it is desirable that Government employees should be placed on a basis of tax equality with their fellow citizens of comparable incomes. In the case of Government salaries, of course, it is the normal tax rather than the surtax which is chiefly at stake, because of the prevailing low salary levels.

Thus, just as the aim of discontinuing the tax-exemption of Government securities is to protect the progressive system, so the aim of eliminating the tax-free privilege for Government employees is to broaden the base of the income tax and more nearly to universalize the visible payment of taxes. The two proposals thus supplement one another, the one being aimed at strengthening the income tax at the top, and the other at strengthening the tax at the bottom.

It may be argued that the imposition of taxes upon Government employees will merely result in increases in their salaries and will not call forth any net contribution by them to the cost of government. The net economic effect, however, is very difficult to predict, since it must depend upon many factors affecting the determination of Government salaries and the incidence of an income tax.

Even if a corresponding increase of Government salaries should result, however, the action would seem justified as a means of bringing about a greater feeling of tax consciousness and a realization of contribution to the cost of government on the part of many of these employees, whose salaries, after all, form much of that cost.

The significance of this point may be greater in the future, however, than at present. Many students of taxation believe that we should, by lowering exemptions and replacing many indirect levies, give the income tax a larger relative place in our aggregate tax structure. The tax would thus be converted into a revenue instrument fiscally more important and less limited in application to the rich.

If such a revision of tax policy is likely in the future, the number of Government employees immune from tax liability under such a tax would be very much larger than at present. If so, it follows that the immunity of Government salaries with respect both to revenue and to tax consciousness has greater importance for the future than for the present. Seen in such future perspective, present action for discontinuance of the tax-free privilege for Government employees is justified, not only as a means of meeting present conditions, but as a program of fiscal preparedness for the years that lie ahead.

The CHAIRMAN. Any questions?

Senator AUSTIN. I have none.

The CHAIRMAN. Professor Williamson, we thank you very much for coming down and giving us the benefit of this excellent statement.

(Mr. Bernhard Knollenberg, librarian, Yale University, New Haven, Conn., testified before the committee on this date (Tuesday, February 14, 1939). Subsequently, at Mr. Knollenberg's request, the committee agreed to eliminate his testimony from the printed record.)

The CHAIRMAN. The committee will be pleased to hear from Prof. William J. Shultz of the College of City of New York at this time.

STATEMENT OF WILLIAM J. SHULTZ, PROFESSOR, COLLEGE OF THE CITY OF NEW YORK, NEW YORK CITY

Dr. SHULTZ. Mr. Chairman and gentlemen of the committee, as an academic economist, I cannot present any new figures, any new calculations, that will throw added light on the effects of the tax-exemption of Government securities and salaries or on the effects of abolishing that exemption. For my statistical material, I am indebted to old researches by Dr. Hardy and others long available to everybody, and to recent statistical analysis by Mr. Henry C. Murphy, of the Treasury Department. The more pertinent of Mr. Murphy's figures have already been presented to you by Mr. Hanes and Mr. Murphy. My contribution can only be to supplement and coordinate the interpretations placed upon these figures.

WHY TAX EXEMPTION OF GOVERNMENT SECURITIES SHOULD BE ENDED

On several past occasions I have written in condemnation of the tax exemption of Government securities:

The Cost of Government in the United States, 1925–26 (National Industrial Conference Board, New York, 1926), pages 139 to 146.

American Public Finance and Taxation (Prentice-Hall, New York, 1931), pages 151 to 156.

Your Taxes (Doubleday Doran, New York, 1938), pages 149 to 150.

American Public Finance (Prentice-Hall, New York, 1938), pages 616 to 622.

My objections may be summarized under four headings:

1. The injustice perpetrated as among various classes of Federal income-tax payers and, to a lesser extent, as among various classes of State income-tax payers.
2. The effects on investment tendencies.
3. The loss of more tax revenue through the exemption than is gained by the lower interest rate.
4. The inconsistent distribution of the gains and losses involved between the Federal Government on the one side and the State and local governments on the other.

INJUSTICES INVOLVED IN TAX EXEMPTION OF GOVERNMENTAL SECURITIES

Tax exemption of governmental securities involves injustice only because of the existence of progressive income taxes. It is because, under the present Federal income-tax schedule, a rich man pays 72 percent on the next $250,000 of his income over $500,000, and a poorer man pays 17 percent on the next $4,000 of his income over $22,000, that the exemption of interest on Government securities is worth more, as an instrument of tax avoidance, to the first individual than to the second.

According to the spread in interest rates between highest-grade taxable securities and tax-exempts, there will be one group of income taxpayers who stand to gain, through tax avoidance, by investing in tax-exempts instead of taxable securities, and another group who gain nothing or actually lose (if no allowance is made for the "safe" and "liquid" character of Government securities) by such investment. If the "interest rate differential" between tax-exempt securities and the highest grade of taxables were one-sixth, under the present Federal income tax all recipients of more than $22,000 taxable income would gain by investing in tax-exempts, while the recipients of less than $22,000 of taxable income would lose by such investment. At that income level, the profit from tax avoidance exceeds the loss of interest income that results from the interest-rate differential. If the interest-rate differential were one-half, the dividing line would be at the $80,000 income level. If the interest-rate differential were three-quarters, the dividing line would be at the $1,000,000 income level.

Not only does the existence of tax-exempt securities and a progressive income tax establish one class of investors who can reap a tax-avoidance profit by investment in tax-exempts and another which loses, but it also discriminates as among the investors who profit in this fashion. As Mr. Hanes said, in his statement: "The value of the tax-exemption privilege varies widely among different purchasers having different incomes; the cost of acquiring this privilege, on the other hand, is the same to all." (Hearings, cit. supra, p. 5.) The larger the taxable income of any individual, the greater is his tax avoidance by investment in tax-exempts. The relative degree of tax-avoidance profit to be derived by richer individuals from investment in tax-exempts depends upon the degree of progression that is embodied in the personal income-tax-rate schedule and upon the interest-rate differential between comparable taxables and tax-exempts. Under the present Federal personal income tax schedule, and assuming a current 3-percent yield on riskless taxable securities and a 2½-percent yield on tax-exempts, a man with $500,000 of taxable income saves 77 percent of his potential additional tax by purchasing up to $8,300,000 of tax-exempts, whereas a man with $22,000 of taxable income saves only 3 percent of his potential additional tax by purchasing up to $133,000 of tax exempts. To the extent that Congress seeks to distribute the burden of the personal income tax upon a "progressive" basis, the existence of tax-exempt securities operates "regressively" to nullify that intent. Under State income taxes, within their more moderate progression, the distributional injustice produced by tax avoidance through investment in tax-exempt securities is much milder, but it is nonetheless present.

Demand for Government securities by investors who seek tax exemption raises the price—or what is equivalent, lowers the interest return—for investors who seek the relative safety and liquidity that such securities offer. From this unquestionable fact it is frequently argued that tax exemption perpetrates an injustice upon the safety and liquidity investors. (Ibid p. 7.) I consider this a weak argument, one that invites side-issue attacks by proponents of tax exemption, and I prefer to clear it away myself rather than leave the attack to them. Demand for Government securities is joint. One set of buyers purchases Government securities for one purpose—tax exemption; a second set purchases for a different purpose—safety and liquidity. The price of the securities—their interest yield—is determined by the joint demand operating upon the given supply. It is true that the existence of the tax-exemption demand forces up the price—that is, lowers the yield—for the safety and liquidity purchasers. But it is equally true that the existence of the safety and liquidity demand forces up the price for the tax-exemption purchasers. There is no justice or injustice involved in this—no more than when demand for copper to make shells forces up copper prices for electrical users of copper, and the demand of the latter forces up copper prices for munitions makers.

Although we may conclude that the feature of tax exemption works no injustice upon "safety" and "liquidity" purchasers of Government securities, there can be no question but that these latter classes of investors would benefit from the abolition of tax exemption. With the present group of tax-exemption purchasers out of the market, prices for Government securities would unquestionably fall—that is, the issuing governments would have to offer a higher interest rate. To whatever extent, even though slight, the yield on governmentals was raised, "safety" and "liquidity" buyers would get a better return on their investment. To the commercial banks, insurance companies savings banks, and trusts that hold such securities, this would be a welcome development.

BAD EFFECTS OF TAX EXEMPTION ON INVESTMENT STRUCTURE

It is a truism of individual investment policy that a substantial reserve of safe, income-yielding issues should be accumulated before a beginning is made on the purchase of more risky junior issues. A man with moderate means, after covering a reasonable cash account, insurance, and possibly home purchase, should buy a nest egg of sound "governments" before he seeks the more speculative industrial bonds and stocks. Conversely, a wealthy individual whose total of wealth allows him a wide margin of ultimate values against all eventualities, does not need the safety of Government issues. He can, and from the standpoint of national economic welfare, he should supply the junior capital which provides economic initiative and control.

Some critics of tax exemption argue that this means of escape from taxation has "turned the investment market on end" (ibid, p. 9), that it has driven rich men to invest in "safety" (as an incident to buying tax exemption), thereby forcing individuals with more moderate means, who shouldn't, to invest in "venture." Such a statement exaggerates. In the first place, with $50,000,000,000 of governmental securities outstanding, there is an ample supply to meet the needs of all investors who properly seek safety. And with the interest differential between tax-exempts and sound taxables now reduced to a trifle, because of the tremendous supply of Government issues and the current low interest level, investors with moderate wealth are not being unduly discouraged by yield reasons from investing in governmentals. Moreover, as study of the composition of estates of rich decedents shows, our wealthy men still keep the major part of their wealth in junior issues. Tax-exempt bonds never gave anyone control over an enterprise. And the power and the opportunities for capital gain that inhere in common stocks are not to be surrendered lightly—even for a substantial tax saving—by the men who can afford to own them. Nor must we overlook that nondistribution of corporate profits, even with an undistributed profits tax in effect, may accord a wealthy holder of common stocks as substantial a tax avoidance as would ownership of tax-exempt Government securities.

But even though the existence of tax-exempt issues may not attract all or most "large wealth" out of venturesome junior investment, and even though the small investor can still obtain "safe" government securities without much of a sacrifice in yield—in short, even though the investment market is not "turned on end"—nonetheless the general investment effect of tax exemption is bad. No one can deny that a substantial amount of "big wealth" is locked in tax-exempts. To the extent that this element of "big wealth" was shifted to industrial placement, it would encourage new issues, which would stimulate general economic activity, or encourage a transfer of venturesome junior securities from investors with less wealth who are less fitted to hold such issues. Abolition of the tax-exemption privilege would eliminate an element of investment distortion now present.

NET LOSS TO GOVERNMENTS

If the governments that issue tax-exempt securities gained more, through lower interest rates, that is lost to the tax-collecting governments through tax avoidance, we might argue, on grounds of expediency, that the profit involved offset the factors of injustice and investment distortion noted above. But issuing governments do not gain more than the taxing governments lose. In a country that employs progressive income taxes, every tax-exempt bond issued involves a revenue loss that outweighs the interest gain.

At any given time, the extent of the net loss sustained by governments because of tax-exempt securities is determined by three factors—the progressive character of the rate schedules of the personal income taxes levied in the country, the amount of government securities outstanding relative to the markets for them, and the current investment interest rate.

If only proportional property or income taxes were levied, taxpayers' gains through ownership of tax-exempt securities—which is an inverse way of saying governmental losses on tax receipts—would be approximately balanced by governmental gains on interest saving. But the existence of progressive Federal and State personal income taxes introduces, as was stated earlier, variations in the tax-exemption value of government securities to different individuals. Under the present Federal tax, a man with $300,000 of taxable income avoids a 72-percent tax on an additional $250,000 of tax-exempt income, while a man with $22,000 of taxable income avoids a 17-percent tax on an additional $4,000 of tax-exempt value. With any given volume of tax-exempt securities on the market, their tax-exemption value, and, hence their price in terms of interest rate, is determined by the marginal set of purchasers who gain least from tax exemption, but whose purchases are necessary for complete absorption of the outstanding issues. The extra-avoidance gain of the inframarginal holders in the higher income brackets is clear loss to the taxing governments. And the extent of this inframarginal taxpayer gain or governmental loss is determined by the scale of income-tax rates. If the income tax is sharply progressive—if there is a big difference between the tax rates on the inframarginal purchasers of tax-exempt securities and on the marginal purchasers—the governmental loss is correspondingly large. If, as in the State personal income taxes, the rate progression is mild, the tax loss on the inframarginal holders of tax-exempt securities is slight.

Senator AUSTIN. The calculations of what the Government saves on interest based upon 1922 do not apply to 1939, largely because of the difference of the securities outstanding. When you speak about the interest differential at the present market at 0.4 of 1 percent——

Dr. SHULTZ. Yes.

Senator AUSTIN. Then you understand my question?

Dr. SHULTZ. Yes. This influence of the volume of tax-exempt securities outstanding on the interest rate differential, explains in part why Professor Lutz's analysis of the interest-saving on tax-exempt issues, based largely on 1922 figures, does not apply fairly to 1939, when the interest-saving is much less.

Senator AUSTIN. What is your estimate of the present interest differential?

Dr. SHULTZ, I am accepting the Treasury's estimate of around four-tenths of 1 percent.

Senator AUSTIN. Now what is the interest differential for the period assumed by Mr. Lutz in 1922?

Dr. SHULTZ. That is covered by Mr. Hardy's book, and it was around 1 percent at that time. I am going on my memory, and I have not checked that up recently at all.

Given any particular degree of income-tax rate progression, the extent of tax loss on inframarginal holders of tax-exempt securities is determined by the amount of such securities outstanding, since it is this amount that determines how far up or down the income-bracket scale the no-profit-no-loss margin of tax-exempt security holders will be established.

Senator AUSTIN. When we were talking a moment ago, were we talking about the absolute or relative value of the tax-exempt privilege in terms of interest rate differential?

Dr. SHULTZ. I was holding that point in abeyance. While I gave absolute figures for the interest rate differentials in 1922 and 1939, my argument really dealt with relative differentials. But the conclusion is unaffected. In 1922 we had a larger relative differential applied to a higher investment rate than today. So the absolute differential was substantially greater than today, which was the essential point of my argument.

Senator AUSTIN. Now you are talking about the absolute interest differential or a relative one?

Dr. SHULTZ. It would have to be the absolute differential, since I am speaking in terms of actual interest saved. If I were to speak of a relative differential dependent upon the amount of exempt securities outstanding I would have to speak of a differential of around one-sixth, or one-quarter, or one-half, or some other ratio.

Senator AUSTIN. Proceed.

Dr. SHULTZ. If only a few hundred million dollars of tax-exempt securities were outstanding, under the present Federal income-tax rate schedule, they would all gravitate into the possession of individuals with taxable incomes over $1,000,000. For such individuals there would be a profit in holding tax-exempts even if their yield were only one-quarter that of corresponding taxable securities. The purchasers would not be willing to sacrifice in lower interest rates the full amount of their tax saving, since they would be surrendering the element of control attached to junior securities, and safety feature of government issues would not be an important consideration to them. But the discount would be slight. With all the purchasers of these bonds enjoying approximately the same tax saving and with all willing to pay—in reduced yield—almost as much as this saving was worth to them, the issuing governments would gain in interest saving almost as much as the taxing governments lost. There would be some loss, but it would be slight.

But with larger amounts of tax-exempt securities outstanding, the demand of individuals in the top-income brackets is fully satisfied, and some of the securities must be bought by individuals in lower-income brackets whose saving is less. Naturally they are going to pay less—that is, insist on a higher yield—than top-bracket buyers. As marginal purchasers, their demand determines the interest differential of the entire volume of tax-exempts. On these marginal buyers, the issuing governments gain in interest differential almost as much as is lost in taxes; but meanwhile, on the inframarginal buyers—the purchasers in the top-income brackets—the tax loss is much greater than the issuing governments' gain.

As the amount of government securities outstanding increases, the margin of purchasers moves ever further down the income-bracket scale, the tax saving possible for the newer groups of purchasers becomes ever smaller, and the interest differential between tax-exempts and comparable taxables shrinks. When the shrinkage of differential has proceeded far enough, a new demand element enters—the "safety" and "liquidity" investors. For awhile, the extent of this new market for tax-exempts may peg the price—as measured by the interest differential—for governmental securities, in spite of a further big expansion of issues. But as expansion continues in the face of an established structure of joint demand—the demand schedules of tax-exemption purchasers plus the "safety" and "liquidity" purchasers—the price of new issues must be brought ever lower, i. e., a higher interest rate must be offered, with the result that the interest differential shrinks still further. Governmental loss through tax avoidance increases as the reduced interest differential makes possible tax avoidance through purchase of tax-exempts by individuals in lower and lower income brackets, at the same time that governmental gain through interest saving grows less and less.

As stated above, the current investment interest rate also affects the net loss inflicted by tax-exempt securities on governments at any given time. While the ratio of the yield of government securities to that of corresponding taxable securities is determined by the volume of government securities outstanding relative to the market demand for them, the absolute amount of this interest differential depends upon the current investment interest rate. If the current yield for sound, taxable securities is 3 percent and the interest differential ratio is one-sixth, government issues can be marketed at a one-half percent interest saving; if the current yield for sound taxables is 6 percent, at the one-sixth ratio the interest saving for governments is 1 percent. Governmental gain through interest saving depends upon the absolute, not the relative, interest differential. Governmental loss through tax exemption is independent of the levels of taxable security yield, government security yield, or interest differential. Therefore the net loss suffered by governments through the issue of tax-exempt securities, is, other things being equal, greater on securities issued at a time of low interest rates, such as the present, and less on securities issued at a time of high interest rates.

The interest-saving gain that governments derive from tax-exempt securities is established, for the life of the issue, when the securities are issued. It is determined by the factors noted above—the progression of existing tax-rate schedules, the volume of government securities outstanding in relation to the markets for them, and the current investment interest rates. The tax-avoidance loss, which is a factor from the moment when the bonds are issued, may change during the life of the issues if the rate schedules of existing taxes are modified, or if new taxes—to which the exemption of the securities applies—are introduced. If the progression of taxes in existence when the issues were marketed is increased, or if new taxes subject to the exemption are introduced, an additional tax loss, over and above what could be calculated at the time of issue, is incurred, because additional tax avoidance becomes possible without any retroactive effect on interest saving. If tax reduction occurs after the marketing of an exempt issue, the tax-avoidance gain of the security purchasers—or, inversely, the governmental loss—is reduced without any retroactive effect on the original interest saving. In a recent book American Public Finance—Prentice-Hall, New York, 1938, pages (618 to 619)—I summarized the historical significance of this feature of tax exemption as follows:

As of 1923 the Federal Government had neither gained nor lost through total exemption of First Liberty Loan bonds from Federal income taxation, it had lost by its partial exemption of later bond issues, and what it had lost through tax-exemption of State and local bonds was in marketing their issues. * * * For the 1920's as a whole, when Federal income tax rates were being reduced and few State income taxes were adopted, a net gain * * * was probably realized on all tax-exempt bond issues. But with the increase of Federal and State income-tax rates during the 1930's, tax-exempt bonds have caused the taxing governments a staggering (supplementary) tax loss.

INCONSISTENT DISTRIBUTION OF LOSSES BETWEEN THE FEDERAL GOVERNMENT AND STATE AND LOCAL GOVERNMENTS

As was stated above, the tax-avoidance loss that governments suffer because of tax-exempt securities depends upon the degree of rate progression in the taxes they levy. The Federal Government imposes a sharply progressive income tax, so that it sustains a substantial tax-exemption loss—estimated between $179,000,000 and $337,000,000 annually. Only 29 States impose progressive personal income taxes, for the most part with very moderate rate progression, so State income-tax losses through tax-exempt securities are relatively slight. So widespread is nonassessment of securities under State and local property taxes, even under the low-mill rates of classified property taxation, that tax exemption can practically be ignored as a property-tax factor. The State and local governments, therefore, lose but little revenue through tax exemption.

Nearly the entire gross tax loss involved in tax-exempt securities is borne by the Federal Government. Such interest saving as is possible with the present low "interest differential" is divided between the Federal Government on the one side and the State and local governments on the other, in proportion to their issues of securities. It is possible that a few of the States with progressive income taxes are in the same position as the Federal Government of losing more through tax avoidance, accomplished by the agency of tax-exempt Federal issues as well as by their own nontaxable bonds, than they gain on interest saving. But unquestionably most of the State and local governments at the present time enjoy a net gain through their power to issue securities exempt under the Federal income tax.

The Federal Government is paying a hidden subsidy to many of the States that costs it several times more than the net gain to the States.

Senator AUSTIN. Have you observed to what extent the States of the Union have opposed this proposal?

Dr. SHULTZ. No, sir. I cannot say anything on that point at all. I state later on that I believe it would be difficult to obtain ratification of a constitutional amendment dealing solely with abolition of the tax exemption of Government securities.

Senator AUSTIN. I gather from your answer that you have the impression that the States by virtue of their interest would be opposed to such a constitutional amendment?

Dr. SHULTZ. Yes.

Senator AUSTIN. And so you have got to add the fuel of interest to the fire of patriotism in order to get them to adopt this, have you not?

Dr. SHULTZ. I think that there would be some basis for that statement in the discussions that took place at the time the sixteenth amendment was enacted. The question was raised by the New York Legislature or Governor Hughes, I think, at that time, whether the amendment would make the interest on State and local securities taxable. The implication was that they would not have ratified the amendment if that had been its effect.

Before I begin this next discussion I think that I should add that I am an attorney; that I have studied and written in the field of constitutional law; so upon those points let us say that I speak as a lawyer as well as an economist.

HOW TO END THE EXEMPTION OF GOVERNMENTAL SECURITIES

There are four possibilities of congressional action to eliminate the abuse of tax-exempt securities:

1. A resolution forbidding future issues of Federal securities carrying exemption from Federal taxation.

2. Enactment of a statute, in accordance with the Presidential message of April 25, 1938, specifically including interest on State and local obligations in the concept of "taxable income" under the Federal income tax, with or without a reciprocal waiving of immunity of Federal issues from State and local taxation.

3. Amendment of the Federal income tax, to change it from a tax "on income," as authorized by the sixteenth amendment, to an excise "on the act and transaction of receiving income measured by net income received."

4. A constitutional amendment.

Possibilities two and three above are alternatives. Possibilities one and four, together with the alternative two or three, could be pursued concomnitantly.

RESOLUTION ON FUTURE FEDERAL ISSUES

For reasons stated earlier, every Federal or Federal instrumentalities issue carrying full tax exemption would involve the Federal Government in a substantial tax loss. Partially exempt issues, whose exemption does not apply to the personal income surtax, involve a mild loss, since no individual or institution will pay more—in acceptance of lower interest rates—than his gain through such partial exemption, and in all probability will pay somewhat less.

A resolution forbidding future issuance of Federal or Federal instrumentalities securities exempt from Federal taxation will not, of course, affect the exemption privilege of outstanding issues.

TAXATION OF "TAX-EXEMPT" INTEREST UNDER THE PRESENT INCOME TAX LAW

I am none too optimistic on the possibility that extension of the Federal income tax in its present form to the interest on outstanding or future State and local obligations would be sustained by the courts. I feel that Mr. James Morris made out a much too optimistic analysis of the Supreme Court's recent approach to the issue of Federal taxation of State instrumentalities. (Hearings, cit. supra, pp. 36 to 52.) Not one of the cases cited by Mr. Morris questioned or weakened the basic proposition, established in *Collector* v. *Day*, and *Pollock* v. *Farmers Loan & Trust Company*, that basic functions and instrumentalities of the States—in which category State and local borrowing and State and local bonds must fall—may not be taxed or subjected to other interference by the Federal Government. The decisions in

Flint v. *Stone Tracy Co.*, *Educational Films Corp.* v. *Ward*, and *Pacific Co.* v. *Johnson* turned on an issue which I will discuss later—the doctrine of "subject and measure." The inheritance tax cases mentioned by Mr. Morris also involve this issue. The line of cases represented by *Metcalf & Eddy* v. *Mitchell* and *James* v. *Dravo Contracting Co.* accept the fundamental principle of the freedom of basic Federal or State functions from taxation by each other, and merely construe certain functions as "contractual," "proprietory," or "incidental," and hence not protected by the principle that covers the basic functions and instrumentalities. Nowhere in the hundreds of tax cases that have been decided by the Supreme Court since *Pollock* v. *Farmers Loan & Trust Co.* is there the faintest indication of any intention to overrule the fundamental principle.

I do not wish to be understood as saying that what the Supreme Court has created it cannot unmake. The principles that the Federal Government may not tax State instrumentalities, and that the State and local governments may not tax Federal instrumentalities, are judge-made law, and judges can overrule them. But overruling of such fundamental law is a step that the Court would be utterly averse to taking. Possibly the present members of the Supreme Court would take that step. My personal conviction is that they would not.

AMENDMENT OF THE TAX TO MAKE IT AN EXCISE ON THE RECEIPT OF INCOME

Although the Supreme Court might refuse to overrule a fundamental element of established economic law, if it were provided with a legal fiction that would enable it to sustain nondiscriminatory Federal taxation of State instrumentalities and nondiscriminatory State taxation of Federal instrumentalities without specific overruling of established law, it might well make use of that fiction to further the purposes that the President has in mind. As it happens, there is such a legal fiction, created by the Supreme Court, at hand.

In *Flint* v. *Stone Tracy Co.*, about which the chairman of this committee questioned Mr. Morris, the Court established the fiction that every tax has a legal subject on which the tax is imposed and an economic measure to which the rate of the tax is applied. In this case, a Federal corporation income tax which included as taxable income the interest on State and local bonds held by the taxed corporation, was held valid on the ground that the legal subject of the tax was the act of doing business as a corporation—a permissible subject for a Federal excise. The *Pollock case* was not overruled, but simply held not to apply to the situation under consideration, since the Pollock decision turned upon a tax whose subject was income.

This legal fiction of the "subject and measure" of taxes had had a checkered history, sometimes employed, sometimes ignored by the Court. During the 1930's the Supreme Court has made liberal use of it to sustain State corporation income taxes applied to income from Federal bonds, to the income of a bridge company whose earnings were derived from international traffic, and to other elements of income which might have been thought, under older principles of tax law, to be exempt from State tax powers. Congress took note of the Court's use of this fiction in 1926, when it amended R. S. 5219 to permit States to tax national banks under special excises "measured by net income," thereby enabling the States to include interest on Federal bonds held by banks as part of the measure of their bank taxes.

I suggest that this fiction of "subject and measure" might be used to frame a Federal income tax applying to the interest on State and local securities. With the phraseology of the tax law amended so that the tax becomes "an excise on the act and transaction of receiving income by individuals and corporations, measured by the net income received," the Supreme Court would be able to sustain the taxation of interest on State and local securities without overruling established fundamental law. Perhaps the Court would choose not to accept this avenue of escape. If that should be its temper, be sure that it would never ratify the approach suggested by the President. But there is also the important possibility that it might accept this avenue of escape, whereas it would refuse flatly to overrule the older law.

Senator AUSTIN. May I ask a question at this point?

Dr. SHULTZ. Surely.

Senator AUSTIN. Do you take that position because you feel receiving income by an individual or by a corporation is doing business?

Dr. SHULTZ. No. You will notice that while the corporation income tax of 1909 was interpreted by the Court as an excise on the act of doing business by the corporation, that would not apply as to individuals.

Senator AUSTIN. Yes; but let me call your attention to something that has just been handed to me. On page 105 of The Taxing Power of the Federal and State Governments, a report of the staff of the Joint Committee on Internal Revenue Taxation. In *Jensen* v. *Henneford; Bronson* v. *Same* (Washington, 53 P. (2d) 607), the Court said:

> The right to receive property (income in this instance) is but a necessary element of ownership, and, without such right to receive, the ownership is but an empty thing and of no value whatever. * * * The mere potential privilege of receiving earned income amounts to nothing unless and until the income is received. The right to receive, the reception, and the right to hold, are progressive incidents to ownership and indispensable thereto. To tax any one of these elements is to tax their sum total, namely, ownership, and therefore, the property (income) itself.

Now, if that is so, the act would be unconstitutional, would it not?

Dr. SHULTZ. That opinion, Senator, is derived directly from the statement of the Federal Supreme Court in the *Pollock case*. That is the position upon which the Court there held the Income Tax Act of 1894 unconstitutional, namely, that a tax upon income was a tax upon the property itself, and hence a direct tax, and one that had to be apportioned among the States. The Supreme Court later in a case involving the Union Pacific Railroad Co. overruled that particular aspect of the *Pollock case*.

Senator AUSTIN. Then I gather you take this position in this statement, to wit, that the phraseology of the tax law——

Dr. SHULTZ. Yes.

Senator AUSTIN. You take that position on the assumption that the Supreme Court has overruled this principle that I called your attention to in the *Jansen case*?

Dr. SHULTZ. Yes, I might state that, in a number of States with respect to State income taxes, where no Federal issues are involved, the courts have held and still do that the income is a feature of the property behind it. It is so held in New Hampshire. But so far as the tradition of the Federal law is concerned, that is not so. And then we have the inheritance tax cases. The Supreme Court has sustained the Federal tax upon the transfer of property as a valid tax since it is an excise.

Senator AUSTIN. Now are you referring to the trust during life?

Dr. SHULTZ. No. I am considering the transfer of property at death. The Federal estate tax is upheld as the excise on the act of transfer of property at death.

The Federal Government cannot tax the property but through the use of this principle, subject and measure, an estate tax is upheld on the theory that the subject of the tax is an act of transfer. The measure of the tax is the value of the property. I am suggesting that the same principle be applied to income taxation, so that even though the Court might hold that the Federal Government cannot tax directly income from State and local securities, nonetheless the Court might hold that the Federal Government could tax the act of receiving income.

Senator AUSTIN. It is on that theory, isn't it, that the incidence of such tax is the date of death?

Dr. SHULTZ. Yes; that is one of the reasons why the calculation must be from the date of death, Federal tax, rather than date of receiving the property by the heirs.

CONSTITUTIONAL AMENDMENT

If a statute to abolish the exemption privilege of Government securities can be drafted so as to be sustained by the Supreme Court, by all means let the reform be accomplished by this direct, quick route. The only way to determine whether the Court will sustain such a statute is to pass it. There will be no paucity or delay in cases to carry it before the Court. If the statute is not sustained, the situation will be no worse than it is now.

There are two objections to proceeding to abolish tax exemption by constitutional amendment. One, the obvious one, is the delay involved. The second derives from the circumstances noted above that "most of the State and local governments at the present time enjoy a net gain through their power to issue securities exempt under the Federal income tax." This being so, can it be expected that three-quarters of the States would deprive themselves of a net advantage by ratifying an amendment ending that advantage?

If it proves impossible to abolish tax exemption of Government securities by statute, then there will be no alternative but to try the amendment route. In such case, it will be politic to combine the proposal to abolish tax exemption with some other proposal of advantage to the States.

Senator BYRD. Did I understand you to say that some States were taxing interest of Federal bonds?

Dr. SHULTZ. Yes.

Senator BYRD. What States?

Dr. SHULTZ. There are six States. I do not have them listed, but I will be glad to provide you with that list by correspondence. Furthermore bank incomes are taxed, under that provision of R. S. 5219 that the bank tax shall be on excise, measured by income, including the interest of Federal bonds.

Senator AUSTIN. That is by consent given by the Congress to tax an agency of the Government?

Dr. SHULTZ. I believe that a general State corporation income tax could be applied in this same way to Federal bond interest. The case of *Educational Films Co.* v. *Ward* was a case, as I remember, applying to the general State corporation tax, the right being exercised upon the privilege of doing business as a corporation, measured by the net income, and the Supreme Court upheld the State corporation tax.

A suggested tie-up would be an amendment clause modifying the limitations upon State tax and regulatory powers under the interstate commerce rule. State officials have long urged an amendment on this subject—I believe that the question has been several times before Congress—and the two reforms combined might receive ratification where the tax-exemption proposal alone would fail.

RECIPROCAL ESTENSION TO STATES OF TAXING POWERS OVER FEDERAL SECURITIES

Whichever method of extending the Federal income tax to interest on State and local securities is enacted, the State and local governments should be granted reciprocal right to tax Federal securities. This might well prove to be merely a formal gesture, since, if the "subject measure" principle should be upheld as a method open to the Federal Government of taxing State and local issues, the same principle would be available to the State and local governments to extend their taxes to Federal securities. Indeed, as already pointed out, some of the State governments are already utilizing this principle to tax the interest on Federal bonds.

Authorities on constitutional law are in dispute as to whether Congress can waive an incident of Federal sovereignty, such as the immunity of its instrumentalities from State and local taxation. To me, the weight of argument seems unquestionably for the proposition that it can waive this particular court-created incident of sovereignty. The line of Supreme Court bank tax decisions on R. S. 5219 seems unanswerable authority for this proposition.

The CHAIRMAN. You base that differential at 15 percent?

Dr. SHULTZ. Yes; and not only the 15 percent relative differential but the investment rates.

APPLICATION OF THE PROPOSED TAX TO OUTSTANDING OR TO FUTURE ISSUES

If abolition of the tax-exempt privilege were accomplished by revising the phraseology of the Federal tax to conform with the "subject measure" principle, the precedent of Supreme Court decisions would indicate that the tax could be applied to outstanding tax-exempts, Federal as well as State and local. *Pacific Co.* v. *Johnson* may be cited as authority for this conclusion. Whether it would be advisable so to extend the tax is another question.

Beyond doubt all present holders of tax-exempt securities who purchased them for their "exemption" value would feel that they had been made the victims of a superfraud on the part of the Federal Government. They sacrificed a small "interest differential" to buy the tax saving. Now they would be deprived of their tax saving—itself a matter for intense bitterness—without compensation for their sacrifice. The Treasury Department and this committee have expressed awareness of this point.

But to the minds of some, an important economic consideration may overrule this ethical consideration. If the proposed tax should apply to future issues of governmental securities, a long time—estimated up to 50 years—must elapse before all tax-exempt securities are eliminated. Over this period, there will be a constant shrinkage of the volume of tax-exempt securities outstanding, with the retired issues replaced by taxable ones. Investors in "safety" and "liquidity" will purchase the new taxable issues, while seekers after tax exemption will continue to buy the outstanding tax-exempts. There will be a slow but steady shift of the remaining tax-exempts from "safety" and "liquidity" investors to "exemption" investors. When the supply of outstanding tax-exempts shrinks to the point where it is somewhat less than sufficient to supply the total demand of "exemption" investors, recipients of large incomes, to whom the exemption privilege is worth more than to small-income recipients, will begin to bid away the remaining tax-exempts from smaller-income investors by offering a premium. The "margin" of tax-exempt investment will start moving up the income-bracket scale. The more the supply shrinks, the higher the margin will rise, and the higher will be the premium offered on the remaining tax-exempts. True, the "exemption" profit to large-income recipients from ownership of tax-exempt securities will be diminished by the substantial premiums they will have to pay for those securities. But, although the large-income recipients will find their "exemption" profit reduced, the taxing governments will not be the gainers. The premiums in question will constitute an "unearned increment" received by prior holders of the securities.

The moment that a law taxing the interest on future government issues went into effect, all issuing governments would have to increase the rate on their offerings by the present small "interest differential." The interest saving to issuing governments would therefore be lost immediately. But the revenue loss to the taxing governments and the injustices of tax-exemption discrimination would continue unabated for 20 or 30 years longer. And then, for another 20 years, there would be a gradual abatement of the injustice and the tax loss, during which time every transaction in outstanding tax-exempts would yield the prior holders an "unearned increment" in the form of a rising premium on these securities.

Granted that abolition of the tax-exempt privilege on all outstanding governmental securities would work an injustice upon the present holders of these securities. But continuation of the tax-exempt privilege for the present outstanding volume governmental securities will continue for another half century most of the tax discrimination injustice that we want to end, it will not bring in a penny of additional revenue to the taxing governments for at least another quarter of a century, and it will produce an unjust flowering of unearned increment. It is an open question where the balance lies between these sets of injustices.

A practical compromise might be to allow a 10-year extension of the exemption privilege to outstanding issues. At the present time, because of the tremendous volume of government securities outstanding and the low current interest rates, the market value of the exemption privilege—as evidenced by the "interest differential"—is quite low. This market value is a capitalized value—the value of this year's exemption to an average holder of a tax-exempt security, plus the discounted value of next year's exemption, plus the further discounted value of the following year's exemption, and so on for the life of the security. The discount that is applied to the value of exemptions 10 years or more in the future is so great that in the present "interest differential" or market price of tax-exempt securities with a life greater than 10 years it is an infinitesimal figure. This infinitesimal value of exemptions 10 years or more hence could be abolished with practically no sacrifice to present holders of the securities—not so much sacrifice as is involved in many cases by the month-to-month market variations in the prices of these securities.

ABOLITION OF THE EXEMPTION OF GOVERNMENT SALARIES

The issue of tax-exemption of government salaries is less complicated than the controversy over government securities.

Unlike interest yields, salary determination does not involve minute calculation of relative competitive returns. I consider Mr. Hanes in error when he states that government salaries are lower than business salaries by the amount of the tax exemptions involved. A Federal or State salary of $3,000, or $6,500, or $12,500, or any other round figure, is not established with any fractional-dollar tax-exemption in mind. Practically all governmental salaries are established arbitrarily, without consideration of the tax-exemption feature. The exemption of Federal salaries from State taxation, or of State salaries from Federal taxation, is just extra "velvet" for the fortunate recipients.

Quite properly, income-tax payers feel that this "velvet" enjoyed by government employees is an injustice, a discrimination against themselves. This "ethical" argument is the main reason for eliminating the exemption—the $16,000,000 that the Federal Government will obtain from taxable State and local salaries is a minor item.

Since government salaries are established without consideration of the exemption involved, it is improbable that abolition of the exemption will cause any increase of government pay rolls. If you accomplish this reform New York City will not increase my salary at its municipal college by a single dollar. The tax will come out of my pocket. And much as I shall personally deplore the resulting impoverishment, I do not see that I have any impersonal basis for objection, since I belong to the class that has been enjoying "velvet."

What I have said above upon the constitutional issues surrounding elimination of the tax-exempt privilege of government securities applies to elimination of the exemption of government salaries. While the Supreme Court has recently limited the principle of government salary and payment exemption by holding that it does not apply to payments made in the course of contractual, proprietary, or incidental functions, it has not questioned the basic principle. Rephrasing of the income-tax statute in accordance with the "subject-measure" doctrine seems to me the most likely statutory approach. If the Court will not sustain the tax on the basis of this fiction, a constitutional amendment is the only alternative procedure.

Senator Austin. Will you permit a question?

Dr. Shultz. Yes.

Senator AUSTIN. Perhaps if we should take just the opposite premise to that which you take, and assume that the taxation of salaries of employees of both Federal and State is to be imposed——

Dr. SHULTZ. Yes.

Senator AUSTIN. Wouldn't these employees look for an increase adequate to that additional burden regardless of whether their salary was fixed arbitrarily or not?

Dr. SHULTZ. I read my report to some of my teaching associates and they protested against my taking that position. However, if they believe that their salaries would be increased to such an extent as to take care of the burden, I do not believe they would have any objections to it.

Senator AUSTIN. Very good. Now let us go one step further and inquire whether, in your opinion, in your character as an economist, to say nothing about your facility as a lawyer, in your opinion would there be any adequate gain to compensate for the labor and the cost in making this change?

Dr. SHULTZ. The only gain that I see there would be that Mr. Westbrook Pegler would have one less tomtom to beat. We come back to this proposition, a sense of injustice on the part of the taxpayers. One of the speakers also suggested the element of tax-consciousness—that if the recipients of government salaries were made to feel that they also had to contribute to increased government expenditures, perhaps they would be less likely to be partisan.

Senator BYRD. You do not contend the cost of administering the act would be anything like the income?

Dr. SHULTZ. No. It would be taken care of by the machinery already set up and the additional cost of bringing in one more group of salaries, would be fractional.

Senator BYRD. Thank you, very much. It has been an interesting statement. I believe that we next have the privilege of hearing from Prof. Paul Studenski, of New York University.

STATEMENT OF PAUL STUDENSKI, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY, NEW YORK CITY

Dr. STUDENSKI. Gentlemen of the committee: I have prepared a paper which it will require from 20 to 25 minutes to deliver. Before starting with it I should like to know whether you will have the patience before lunch to hear some more economic doctrine.

Senator BYRD. Proceed, and be as concise as you can, please.

Dr. STUDENSKI. I may say at the outset that besides having taught public finance for a number of years at New York University, and being in charge of most of the courses in public finance given at that university I have been for some 25 years consultant to State and municipal governments in matters of public finance and taxation.

As recently as last year I acted as consultant to the New York State constitutional committee and prepared for the committee a volume on the problems of taxation and finance. For the past 5 years I have acted as consultant to the New York State Commission for the revision of the tax laws.

I have also acted in the past few years now and then as part-time consultant to some Federal agencies, such as National Resources Committee. At the present moment, though I am not doing any work for the Social Security Board, I am on the staff of the Board as principal consulting economist.

I am giving you this background so as to indicate to the committee that I have no bias in favor of either the Federal Government or the State and local governments.

The issues involved in the proposal considered by your committees are fiscal, economic, and political in character. I shall confine my remarks to the fiscal issue.

One of the fiscal issues most prominently discussed before your committees involves the question as to the extent of the gain in public revenue and losses in the higher costs of borrowing which would result from the subjection of future issues of public securities to reciprocal Federal-State taxation, and whether or not the gains will sufficiently offset the losses to justify a change in the existing arrangements.

At the outset it is important to indicate that, inasmuch as this proposal would subject to taxation only future issues of Federal, State, and local bonds, its main effects lie in the future. The immediate gains in revenue and the immediate losses in higher cost of borrowing, would be relatively small. For the volume of new emissions each year will represent but a fraction of the existing wholly or partially exempt debt. Assuming the present rate of growth in State and municipal indebtedness (the taxation of which constitutes the central aspect of the proposal), that is assuming the issuance of approximately $1,000,000,000 of new long-term bonds of States and municipalities every year——

Senator BYRD. Do you estimate that $1,000,000,000 increase will continue indefinitely?

Dr. STUDENSKI. No; I asume the possibility of an increase from one billion to one billion and a half a year for the next 15 years, and I say that it will take between 15 and 20 years before the greater part of the present $20,000,000,000 of State and municipal debt will be retired.

Senator AUSTIN. Are you speaking of refunding of the bonds?

Dr. STUDENSKI. The retirement——

Senator AUSTIN. I understood you to say there would be a billion dollars new issue on the part of the States?

Dr. STUDENSKI. New issues annually for public improvements and other purposes. They may include a certain amount of refunding.

Senator BYRD. What I would like to know is what is your opinion of the additional bonds that will be issued?

Dr. STUDENSKI. In the main my calculations take consideration of the additional bonds for new public improvements.

Senator AUSTIN. Is part of the $1,000,000,000 for refunding purposes?

Dr. STUDENSKI. I assume a small part.

Senator AUSTIN. Practically all of it you estimate will be for additional bonds?

Dr. STUDENSKI. Exactly.

Senator AUSTIN. Then within 20 years the local and State bonds will double by that?

Dr. STUDENSKI. The new issues would in the main replace the retired issues now outstanding. There will be some growth in the debt. What the debt will be 15 or 20 years from now, whether it will be 30 billions of dollars or more, no one naturally can predict.

It will take between 15 and 20 years before the greater part of the present $20,000,000,000 of wholly tax-exempt State and municipal bonds will be retired and $20,000,000,000 of new taxable State and municipal securities will be issued. Despite this obvious fact, it seems to be the prevalent impression that the proposal will result in large immediate gains in Federal revenue on the one hand, and large immediate offsetting losses by way of higher costs of State and municipal borrowing on the other. Mr. Hanes, the Under Secretary of the Treasury, in presenting on January 18, Treasury estimates of large gains in revenue and large increases in interest costs, pointed out that they deal with the distant future and not with the period immediately ahead.

By contrast, Prof. H. L. Lutz, in a voluminous report prepared for Mr. Morris S. Tremaine, comptroller of the State of New York, has failed to make this reservation clear in his estimates, and many witnesses appearing before your committee have used his figures. In the first paragraph of his conclusions as to the probable effects of the adoption of the proposal, Professor Lutz says: "Federal taxation of State and local securities would cost the States and municipalities a minimum of $113,000,000 annually in increased interest cost."

He should have inserted after the words "would cost the States and municipalities" the words "eventually, when the volume of taxable State and local securities would be as large as the existing volume of nontaxable State and local debt." This situation, I have already pointed out, would occur 15 to 20 years after the adoption of the proposal. Actually, on the basis of the present volume of new emissions of State and municipal bonds, the immediate increase in the interest costs to the States and municipalities, even using Professor Lutz's own methods of computation, would be only $6,000,000 the first year and $12,000,000 the second year.

Senator AUSTIN. Do you, in making that statement, adopt Mr. Lutz's premises as correct?

Dr. STUDENSKI. Yes, yes; but I think that he overlooked the slowness of the growth in the volume of new taxable bonds each year and his computation should have been made on the basis of gradual increase in the volume from year to year.

Senator AUSTIN. Well, taking his report in the light of your view, you would still have an additional cost, as you say to the States, of $6,000,000 the first year and $12,000,000 the second year?

Dr. STUDENSKI. Yes.

Senator AUSTIN. And would increase in some regular ratio as you come up the scale to 15 or 20 years?

Dr. STUDENSKI. Yes; I think this progression would take place. As you will note, in the first paragraph of his conclusions as to the probable effect of the adoption of the proposal, Dr. Lutz says:

> Federal taxation of State and local securities would cost the States and municipalities a minimum of $113,000,000 annually in increased interest costs.

And this situation, I say, would occur 15 to 20 years after the adoption of the proposal.

In the same paragraph Professor Lutz says:

> The Federal revenue from such taxes (on State and local securities) is estimated at an average of $95,000,000.

Here, too, the qualification referred to above should have been inserted. As will subsequently be brought out the immediate Federal revenue from this source will be negligible. Only in the more technical parts of the report does the author state that his calculations are "based on the conditions assumed to prevail when the volume of State debt subject to taxation becomes as large as the present immune debt" (p. 121). But even here no indication is given as to when this condition will obtain. The author translates his estimates into specific figures of costs to different States and municipalities without indicating when they will eventuate. He conveys the impression that they will materialize immediately.

On the basis of Professor Lutz's calculation, Mr. Tremaine in his own brief, after estimating the municipal indebtedness in his State in 1937, at over $3,160,000,000 declares that "the municipalities of the State of New York would, therefore, be faced with the possible increased interest costs of about $30,500,000 a year." Other briefs, likewise, give the same erroneous impression that large immediate increases in interest costs to State and municipal governments would follow the adoption of the proposal. Thus, Mr. F. B. Fernhoff, the representative of the California League of Municipalities, said on February 11 that on the basis of Professor Lutz's calculations, "California State and municipal governments would be compelled to shoulder, in financing charges, about $9,100,000 additional cost every year," if the proposal is adopted. Mr. F. A. Pallotti, attorney general of Connecticut, said in his brief: "Connecticut cities and towns would have to pay an additional $1,000,000 a year higher interest if the Federal Government should ever succeed in taxing our bonds." Mr. Harry McMullan, attorney general of the State of North Carolina, said of this proposal: "This means that North Carolina's State and local interest costs will increase in excess of $3,000,000 per year * * * if, as, and when the income upon its bonds is subject to a Federal tax."

Senator AUSTIN. Do you know whether the briefs of those persons that you refer to specifically are founded upon the State debt of their own States, respectively, as of the present date?

Dr. STUDENSKI. That is indicated, Senator, and implied in the statements. Some of them stated it, directly.

Senator AUSTIN. All right. If that is true, what is there erroneous about it?

Dr. STUDENSKI. The error, Senator, is in assuming that this will be an immediate increase, when, as a matter of fact that amount of increase will take place only at some distant future—15 years or more, when there will be an amount of taxable bonds corresponding to the amount of bonds of their State and community now outstanding, which are——

Senator AUSTIN. That is to say that you have to assume that the tax would relate only to future issues?

Dr. STUDENSKI. Yes, Senator.

Senator AUSTIN. And it will not relate to refunding?

Dr. STUDENSKI. It will relate to refunding issues.

In reality, even on the basis of Professor Lutz's own estimates of the probable increase in interest rates on State and local borrowning which would result from the adoption of the proposal, the immediate added burdens to the States or cities represented by these witnesses would be less than one-fifteenth of those quoted by them and the increase in these burdens would be slow and gradual in nature. Moreover, there is great likelihood under the present conditions of the money market that no immediate rise in the costs of State and local borrowing, of any sort, would result from the adoption of the proposal.

I am citing these facts by way of illustration of the exaggerated notions of the immediate effects of the adoption of the proposal on the costs of borrowing, which are rapidly gaining foothold among our State and local officials as a result of the misleading figures presented in Professor Lutz' report. Even Mr. LaGuardia, the mayor of the city of New York, who is a practical expert in municipal finance, was so impressed by Professor Lutz' figures that he said of the proposal, according to newspaper quotations, that "It will hit us right between the eyes," and the other day proposed an elaborate plan for the distribution by the Federal Government to States and municipalities of a subsidy to meet the increased costs of their borrowing, which would supposedly result from the adoption of the proposal.

In addition to giving the erroneous impressions as to the immediacy of these large increases in the costs of public borrowing, Professor Lutz tends to underestimate the offsetting increase in the public revenue which would result from the reciprocal taxation of Federal, State, and local bonds. Thus, Professor Lutz estimates the gains which the Federal Treasury would obtain from the taxation of the income from the existing volume of State and municipal bonds at an average of $95,000,000. A careful examination of the methods employed by him in arriving at this figure, as described on pages 120 to 123 and in the appendixes F and G, reveals therein certain fundamental flaws. The author has used as a basis for his computation of the expected revenue yield from Federal taxation of State and municipal bond interest the distribution among individuals of holdings of partially exempt securities, although this distribution is obviously the reverse of that of individual holdings of State and municipal securities. The latter type of securities, being wholly exempt, tend to concentrate in the hands of the wealthy, while partially exempt securities tend to concentrate in the hands of corporations and recipients of smaller incomes. The figures of the Bureau of Internal Revenue (Statistics of Income for 1936, pt. I, p. 30) show that of the total volume of State and municipal securities owned by individuals, 52 percent are held by individuals with net taxable incomes in excess of $50,000, and that of the volume of partially exempt securities held by individuals, less than 20 percent is held by individuals in the latter income group. By using a distribution of bond ownerships showing unduly low ownerships of State and municipal securities among taxpayers subject to high surtaxes, Professor Lutz arrives at an unduly low estimate of the probable yield of Federal taxes on the interest from State and municipal bonds. The author has supplemented this method of computing the tax yield with another that appears to be even less reliable. Why he has failed to use the figures of the Bureau of Internal Revenue giving the actual distribution of the ownership of State and municipal bonds among individuals, is not clear.

The contrast between the figures given by Professor Lutz in his report and those presented by Mr. Hanes to the committee is striking. Mr. Hanes estimated the ultimate gain to the Treasury from Federal taxation of interest on State and municipal bonds at between $107,000,000 and $198,000,000, or at about 50 percent more than Professor Lutz. While it is evident that Professor Lutz's estimates are based on false assumptions, the bases of the Treasury estimates are not given. Probably no accurate estimate of the probable yields can be made because of the many variable factors involved, which may account for the wide spread between the Treasury's minimum and maximum estimates. Still it would be desirable to have the Treasury explain how it arrived at its figures.

Professor Lutz in his report arrives at a most extraordinary statistical conclusion regarding the fiscal facts of the proposal. He examines the probable gains in revenue which would redound to the Treasury from the taxation of State and local securities, on one hand, and the losses which the States and local governments would sustain from such taxation in the form of higher interest costs thereof, on the other, and he concludes that the losses will outweigh the gains. Similar computations are made by him as to the effect of State taxation of Federal securities, and of Federal taxation of its own securities, and in each case he likewise finds that the losses will outweigh any possible gains. Thus, in his opinion, the net effect of the proposal would be a loss to the public purse as a whole. I hold in my hand a chart in which Professor Lutz's conclusions are presented in a graphic manner. I doubt very much that the complexities of the problems and the multiplicity of varying factors which must be taken into account would permit of any accurate computation of the net fiscal effects of the proposal.

Without going into any statistical computations, I wish to advance here one or two very simple propositions relating to the possible fiscal effects of the proposal. It has been established that only one-third of the $20,000,000,000 of outstanding State and municipal bonds is held by individuals with net taxable incomes of more than $15,000 a year to whom the complete exemption privilege is of great importance. Two-thirds are held by corporations and individuals to whom this complete exemption affords little benefit. Obviously, if the proposal is adopted, there will be a gradual shift in the ownership of the outstanding wholly exempt State and municipal bonds, wealthy individuals buying them from corporations and recipients of smaller incomes. This reservoir of wholly tax-exempt bonds, a part of which will be available for a transfer to wealthy individuals, aggregates at this moment some $12,000,000,000. Consequently, for some time after the adoption of the proposal, the avoidance of Federal surtaxes by wealthy individuals may continue unabated, and very little additional revenue will probably flow into the Treasury as a result of the taxation of State and municipal bonds. As the prices of whooly exempt State and municipal bonds are bid up, individuals exposed to the lower surtaxes who now find it advantageous to buy such bonds, will no longer find it advantageous to do so. The wholly exempt State and municipal bonds will tend to concentrate in the hands of individuals exposed to the highest surtaxes. As the volume of new issues of taxable State and municipals increases, the extent of the avoidance of the Federal income tax by wealthy individuals through investment in these bonds will grow ever smaller.

The corporations and individuals releasing their holdings of wholly exempt State and municipal bonds, will replace them with new taxable State and municipal bonds, assuming that opportunities for alternative investments have not changed. It is quite possible, therefore, that the rates of interest on the new taxable State and municipal bonds will not rise by even the relatively moderate rate of one-half of 1 percent estimated by several authorities. Professor Lutz appears to have completely overlooked the gradualness of future increases in tax yields and the existence of certain forces which would tend to offset possible increases in the costs of borrowing. Needless to say, the condition of the money market may be such as to prevent any rise in the interest rate on the taxable State and municipal issues.

Serious fears are entertained by many citizens who are actively concerned with the welfare of State and local governments, that the adoption of this proposal will so increase the costs of State and local borrowing in the future as to seriously interfere with the ability of these governments to carry on public improvements. Such fears appear to be unfounded. Even should we assume that the interest costs on new borrowings will increase by one-half of 1 percent, the burden thereof on the State and local budgets at the present rate of growth of State and local debts, would be relatively small. Thus, for example, in the case of the city of New York, which is second only to the Federal Government in the extent of its borrowings, the added cost on the basis of an annual volume of new borrowings of $150,000,000, would be only $750,000 the first year, $1,500,000 the second year, and so on. Assuming that this added cost would have to come out of the real-estate tax, the additional tax burden would amount to less than one-half of 1 cent on every hundred dollars of assessed valuation the first year, 1 cent the second year, and so on.

The owner of a property assessed at $10,000 would pay an additional tax of 50 cents the first year, $1 the second year, and so forth. The immediate costs would be nowhere near the figures quoted by some of the witnesses before the committee. Nor, as I have already stated, is there any positive certainty that the costs will even reach these relatively moderate levels. It has already been indicated, that certain influences may readily operate to check a rise in the interest rates on taxable State and municipal securities.

One other factor needs to be mentioned which will tend to check the possibility of a rise in interest rates on taxable State and municipal debts as a result of the adoption of the proposal. I have reference to the greater care in the management of the fiscal affairs of their State or community which public officials will be forced to exercise in order to insure the credit standing of their State or municipality, when the artificial prop of tax exemption supporting their credit will no longer be available.

Senator BYRD. There has been a great improvement in the handling of county bonds and bonds of small towns by reason of some supervision that has been given by the States. Virginia has done that and lowered the interest rate of the subdivisions of the State. In many instances that supervision has not resulted in reducing the rates yet, because some of the bonds are outstanding.

Dr. STUDENSKI. Naturally. Naturally, but it is showing its effect upon the new issues.

Senator BYRD. But Mr. Lutz does not refer to that though.

Dr. STUDENSKI. I do not believe he does.

No State or municipality whose finances are in order ought to experience any difficulty in obtaining credit under the conditions of the present liquid money market for the financing of worthy undertakings. State, and especially municipal governments, had been borrowing without difficulty for at least a century before the introduction of the income tax and the establishment of tax exemption. Tax exemption of State and municipal bonds is only a comparatively recent development.

The paramount fiscal issue in the proposal before the committee, in my opinion, is the preservation in our tax system of the democratic principle of taxation according to ability to pay. The greater part of our tax system tends to be regressive in nature, that is to bear more heavily on the people of small means than on those of larger means. The only segment of our tax system based on the principle of ability to pay is that represented by our income and inheritance taxes. Although these taxes supply only 14 percent of the entire tax revenue of the country at this moment, their importance is far greater than is indicated by this proportion: they add equity to our tax system as a whole. This is their prime significance. It is exceedingly important, therefore, that these taxes be protected against any possible impairment which might interfere with their effective operation. Those who entertain this view, therefore, look with extreme concern on those developments which tend to controvert the purposes and operation of these taxes, and, in particular, of the most progressive tax among them—the Federal personal income tax. Foremost among such tendencies has been the growing avoidance of the payment of the tax through investment in the wholly tax-exempt State and municipal securities. This tax avoidance undermines the integrity of our tax system and the morale of our taxpayers. We cannot profess to be taxing in accordance with ability to pay, while we are offering a wide loophole to our wealthy citizens to avoid the application of this principle by investing some of their wealth in wholly exempt securities. To save the principle, we must as speedily as possible, close this loophole. I don't know of any other practical means for the accomplishment of this result than that of making all future issues of Federal, State and municipal securities reciprocally taxable.

The preservation of the principle of ability to pay in our tax system is, in my opinion, the paramount fiscal issue involved in the proposal before the committee and should be given precedence over all the other fiscal and economic issues involved. Although the proposal will not close the gap in our tax system immediately, it will at least prevent immediately the further widening of this gap and will close it in a gradual way, eventually.

The exemption of interest on State and municipal bonds from Federal taxation, from a fiscal point of view, is a form of a Federal subsidy to State and local governments for the defrayment of a part of the interest costs of their borrowing. Although the purpose of this subsidy may be a worthy one, its form, in my opinion, is contrary to public interest. For this subsidy is effected by means which impair the vital principle of ability to pay in our tax system. For this reason this subsidy should, in my opinion, be withdrawn as speedily as possible and of course in the most painless possible manner. If a Federal subsidy for the defrayment of some of the costs of State and local borrowing is to be furnished by the Federal Government to our States and localities, it should be furnished in some other form or forms.

Senator BYRD. Thank you very much. Are there any questions? There are no questions, and you have made a very interesting contribution.

Dr. STUDENSKI. Gentlemen of the committee, I have written recently an article on Federal taxation of State and municipal bonds, which I brought along with me, and should you wish it I will leave it with you.

Senator BYRD. Thank you, and it shall be included in the record.

(The article referred to is as follows:)

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FEDERAL TAXATION OF STATE AND MUNICIPAL BONDS

(By Paul Studenski [1])

The question of reciprocal Federal-State taxation of interest on Federal, State' and municipal obligations is of much greater concern to the Federal, than to the State governments. First of all, the Federal Government is dependent for a larger proportion of its revenues on the income tax than is any State. Many States, in fact, levy no income taxes whatsoever and therefore, for the time being at least have nothing to gain from such reciprocal taxation. Secondly, the inducement for taxpayers to invest in tax-exempt bonds so as to reduce their taxes results mainly from the high surtaxes of the Federal income tax. The consequent losses in revenue are, therefore, sustained mainly by the Federal Government. Thirdly, the Federal Government grants only a partial tax exemption for most of its own obligations, whereas State and municipal bonds carry a complete exemption from the Federal tax. As a result of this complete exemption, States and municipalities can borrow money at somewhat lower rates of interest than they otherwise would have to pay, and the obligations of some of the States and municipalities sell at a higher price than comparable obligations of the Federal Government. The yields on these States and municipal issues are actually lower than the yields or corresponding Federal bonds.[2] Thus, the States and municipalities gain at the expense of the Federal Government, which loses revenue far in excess of any gain it procures in lower costs of borrowing.

Today wealthy individuals invest their funds in tax-exempt State and municipal bonds as a convenient refuge against the high surtax rates of the Federal income tax. The immunity of State and municipal bonds from taxation thus seriously undermines the Federal powers to tax and interferes, therefore, with the operation of our constitutional system. Why this undermining of the Federal taxing powers and, hence, of our constitutional system is not being given proper consideration by our legal authorities in their discussions of the constitutional issues involved in tax-exempt bonds, is not clear to a layman like myself.

It is proposed that the Federal Government should tax, under its income tax, interest on all future issues of State and municipal bonds, that the States should tax under their income taxes, interest on all future issues of Federal bonds; and that both the Federal and the State Governments should tax under their respective income taxes interest on the future issues of their own bonds and the bonds of their respective agencies or subdivisions. It is generally conceded that both the Federal and the State Governments are under a moral and, in many cases, also a legal obligation to continue the existing exemption of interest on outstanding issues. It is obvious that the subjection of State and municipal bonds to the Federal income tax constitutes the most important part of the entire proposal because of the constitutional issues involved. The moment these issues are disposed of and the right of the Federal Government to tax the income from State and municipal bonds is clearly established, the problem of gradual elimination of all the existing types of exemption of government bonds from both Federal and State taxation will become relatively simple.

Inasmuch as some States stand to gain from a continuance of the existing exemption of State and municipal bonds from Federal taxation, some citizens therein oppose the rescindment of this exemption in any form whatsoever, whether by a Federal enactment or by an amendment to the Federal Constitution.

[1] Professor of Economics, New York University.

[2] Thus, for example, in October 1938, a New York State bond maturing in 1945, bearing interest at 2½ percent and carrying complete exemption from the Federal income tax was yielding at its then existing market price, 1.20 percent. A Federal bond of comparable maturity, which was only partially exempt, was yielding 1.58 percent.

They place the narrow interest of their State or locality ahead of the national interest. In view of the existence of this conflict of interests in the tax-exemption issue it becomes incumbent on any citizen considering this issue, to determine first of all, whether he would approach it from a local, or from a national point of view. That a socially-minded citizen will be inclined to consider it from the point of view of the national interest appears to be obvious.

SOCIAL AND ECONOMIC EFFECTS OF RECIPROCAL EXEMPTION

Most people who have given any thought to the subject, agree that reciprocal exemption of interest on government bonds from income taxation has very bad financial, social, and economic effects and should therefore be terminated as speedily as possible. They disagree among themselves only with reference to the best method of accomplishing this result. It is conceded generally that tax-exemption results in heavy losses of revenue to the Federal Government, that it diverts the flow of capital from private industry and hence retards industrial growth, that it permits some citizens to escape their proper share of the costs of government, and that it invalidates the ability-to-pay principle of taxation to which we, as a democratic people, are presumably committed. The truth of these contentions can hardly be denied. Ten to twenty years ago the exemption of interest on Government bonds from the Federal income tax was quite commonly defended on the ground that it produced savings for the Government in the form of lower interest charges, far in excess of losses in revenue. Today this argument can no longer be seriously advanced, for the fact that tax exemption under present-day conditions produces the opposite effect is too easily demonstrated.

Some people defend tax exemption on the ground that the present high surtax rates of the Federal income tax are confiscatory in character. It is fortunate from a public point of view, they say, that this escape from discriminatory taxation is open to the wealthy taxpayers. This is a dangerous argument. It places a stamp of approval on a perversion of the law. For no one would contend that the exemption from income taxation of the interest on Government bonds was ever intended to provide such a refuge to wealthy taxpayers. The proposition that the income tax be so perverted, is obviously contrary to the fundamental principle of our democracy that the laws should be obeyed by citizens, even though individually they may take exception to them.

DOCTRINE OF CONSTITUTIONAL IMMUNITY

Some lawyers contend that the Federal Government has no power to tax the receipts from interest on State and municipal bonds. They propound the doctrine of the constitutional immunity of the interest on such bonds from Federal taxation, tracing it to John Marshall's famous decision in which the immunity of a Federal instrumentality (a branch of the Bank of the United States) from State taxation (which was discriminatory in character in this case) was held essential to the preservation of the independence of the Federal Government. It is asserted by these jurists on the basis of this decision and also of the *Pollock* decision of 1894, that the immunity of the interest on State and municipal bonds from Federal taxation is necessary to the preservation of the independence of the States. To an ordinary layman this contention seems fantastic. The writer has never yet heard a layman, however opposed to the proposal to tax the interest on State and municipal bonds under the Federal income tax, seriously contend that such taxation would undermine the independence of the States.

Since under the proposal, interest on State and municipal bonds would be taxed under the Federal income tax in exactly the same manner as interest on Federal bonds, such taxation of interest on State and municipal bonds could not possibly impair the borrowing powers of the States and municipalities without interfering at the same time and in the same manner with the borrowing powers of the Federal Government. If at any time, however, the opposite holds true and the Federal tax in question should become discriminatory in nature as regards State and municipal bonds, appeal could be had to the Supreme Court. That the Supreme Court would not allow such discriminatory taxation, can scarcely be doubted. It is clear, therefor, that ample protections against the improper usage of Federal taxing powers in the matter, exist in our Constitution and that there is no need for making the interest on State and municipal bonds immune from any Federal taxation to make these protections effective. The contention that interest on State and municipal bonds must be kept immune from Federal taxation in order to preserve the independence of the States is in complete discord with the actualities of our political system. It represents a purely legalistic and roundabout approach to a very simple practical problem.

FINDINGS OF RECENT RESEARCHES

Recent papers by Mr. John Philip Wenchel, Chief Counsel to the Bureau of Internal Revenue,[3] and the careful researches conducted into the subject by the Department of Justice during the past year or two[4] clearly establish the fact that the doctrine of immunity of State and municipal bonds from Federal taxation which so palpably offends common sense can scarcely be considered to be the law of the land. It is shown that this doctrine is embodied only in the *Pollock* decision referred to above, and that this decision has been superseded by the sixteenth amendment. The amendment is shown to have negated this decision not only as regards the apportionment of the income tax among the States according to population, but also as regards the nontaxability by the Federal authorities of interest on State and municipal bonds. It is shown by these researches that the phrase of the sixteenth amendment giving Congress the power to tax income "from whatever source derived" was inserted therein for the specific purpose of removing the aforementioned restrictions of the *Pollock* case, and that it was commonly understood in and out of Congress at the time to be aimed at the accomplishment of this result.

Says the report of the Department of Justice on this point:[5]

"There is certainly nothing that was said in the course of this debate (in Congress, on the resolution submitting the constitutional amendment) from which it may be inferred that a single Member of the Congress expected, or intended, that the income from State and municipal bonds, and the salaries of State and municipal officers and employees, should be constitutionally immune under the proposed amendment. On the other hand, every positive utterance in the course of the debates is susceptible of the construction that the Congress did not intend to grant any form of immunity."

Mr. Wenchel says in the paper already quoted:[6]

"The construction placed upon the proposed sixteenth amendment by Governor Hughes received wide publicity throughout the country. This belief was held and strongly expressed by many lawyers and public officials. It was referred to and discussed in the messages of a number of Governors in submitting the proposed amendment to the State legislatures. For example, the Governors of Florida, Missouri, North Dakota, and Oklahoma all agreed with the interpretation of Governor Hughes that the sixteenth amendment extended the taxing power, but nevertheless they urged its ratification. From these sources it seems clear that a large number of supporters of the sixteenth amendment believed that they were conferring upon the National Government the power to subject the interest from State and municipal bonds and the salaries of State officers and employees to an income tax."

When, therefore, Congress, after the adoption of the sixteenth amendment, in enacting its income-tax law, inserted in it a provision exempting from the tax interest on Government bonds generally, it did so apparently for reasons of expediency rather than because of any conviction that such exemptions were required by the Constitution.[7] The Supreme Court has never had an opportunity, since the adoption of this amendment, to pass on the powers of the Federal Government to tax interest on State and municipal bonds under its income tax. The evidence presented by Mr. Wenchel and the Department of Justice gives support to the belief that the Supreme Court will sustain these powers, and that Congress can, therefore, provide by a simple amendment of the Federal income-tax law for the taxation of the interest on all future issues of State and municipal bonds.

Some people believe that even though the Federal Government may have the power to tax the interest on such bonds, it would still be safer to do so by a constitutional amendment. This reasoning seems to us to be palpably weak. The most effective answer to this contention was given by Mr. Nicholas Murray Butler, president of Columbia University, a year ago in the following statement:[8]

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[3] Address on the Legal Aspect of Tax-Exempt Privileges, before the American Bar Association, reprinted in the Congressional Record, May 25, 1938, No. 107, pp. 9908-9911; and address on the Federal Taxation of State and Local Bonds, before the National Tax Association, October 24, 1938.

[4] Taxation of Government Bondholders and Employees. The Immunity Rule and the Sixteenth Amendment. A study made by the Department of Justice. Government Printing Office. 1938. P. 219.

[5] Ibidem, p. 161.

[6] See footnote 3 above.

[7] *Ibidem*, p. 192.

[8] As quoted by Mr. Wenchel, Congressional Record, vol. 83, No. 107, May 25, 1938, p. 9911.

"Senators Borah and Root disagreed with Governor Hughes. Nevertheless, Governor Dix, who succeeded Governor Hughes, urged the legislature of New York to ratify the sixteenth amendment in these words:

"'Indeed, it seems to me that if the words "from whatever source derived" would leave the amendment ambiguous as to its power to tax income from official salaries and from bonds of States and municipalities, the amendment ought to be opposed by whoever adheres to the democratic maxim of equality of laws, equality of privileges, and equality of burdens. * * * It is impossible to conceive of any proposition more unfair and more antagonistic to the American idea of equality and democratic principle of opposition to privilege, than an income tax so levied that it would divde the people of the United States into two classes.'

"There could be no more direct and unqualified grant of power to Congress to tax income from whatever source than is contained in the language of the sixteenth amendment. To adopt now another amendment definitely specifying that the Congress might tax income from sources which have been held exempt because of court decisions subsequent to the sixteenth amendment would be to make us the laughing stock of the world. That would be equivalent to saying that the words 'from whatever source derived' do not mean what they appear to mean, but must be supplemented by a variety of specific designations of sources of income. Out of this situation would arise a new series of court decisions which would exempt the income from sources not specified in the second amendment. The situation would be ludicrous to the point of absurdity."

A fear is expressed by some people that the subjection of the interest on future issues of State and municipal bonds to Federal income taxation would result in a material rise in interest rates on such bonds. Undoubtedly some rise in interest rates on such new issues would result. But this rise would probably not exceed one-half of 1 percent and would be of little immediate consequence, inasmuch as the volume of new issues would be relatively small. Years would go by before the volume of tax-exempt State and municipal bonds would diminish so materially as to vitally affect bond prices and bond yields in the market generally.

SUMMARY

To summarize, the present exemption of the interest on State and municipal bonds from Federal income taxation, is creating an intolerable situation. Steps should be taken immediately to bring about the termination of the exemption at least so far as new issues of State and municipal bonds are concerned. Congress should pass an amendment to the Federal income tax law making interest on such bonds taxable. A test case should then be instituted at the earliest possible time, which would enable the Supreme Court to pass upon the constitutionality of the measure. This, in the main, is the program which has the backing of the President of the United States. People interested in fair taxation have been complaining for years of the evil of tax-exempt bonds. They have now an opportunity to lend their support to a reasonable program for a gradual elimination of this evil.

Senator BYRD. The next witness the committee will hear is Mr. Sydney A. Gutkin, an attorney, of Newark, N. J.

STATEMENT OF SYDNEY A. GUTKIN, ATTORNEY, NEWARK, N. J.

Senator BYRD. How much time do you wish? The reason I ask that question is, I am informed that another committee wishes to use this room for a hearing.

Mr. GUTKIN. I think that I can limit my remarks to 20 minutes, or extend them, if you wish it, at some future date; whatever your pleasure is.

Senator BYRD. Very well. I think that we should adjourn after 20 minutes have been consumed, and, if you have not finished with your remarks at the end of that time, we can put the balance in the record. Limit it to, say, 15 minutes to 1 o'clock p. m., as another committee desires to use the room.

Mr. GUTKIN. Mr. Chairman and members of the committee, I consider it a privilege to have been invited by your chairman to come here to discuss with you the proposal to take legislative action to eliminate any existing immunity from income taxation of the interest on future issues of governmental obligations and compensation paid governmental officers and employees.

In my opinion the primary consideration in connection with the problem is that of policy. Legal analysis and methods should be secondary. I submit that continuation of the exemptions is unwarranted, unsound, and contrary to our American principles of fair and equal treatment, and that steps should and must be taken to end them.

In explanation of my position here, permit me to say that my remarks should not be considered those of a biased proponent of a program. I had the opportunity of viewing the question when I was associated with the office of the Chief Counsel for the Bureau of Internal Revenue, and since then as a taxpayers' representative.

The statement that the exemptions must be removed reflects the consensus of national opinion, as expressed by taxpayers, editorial writers, economists and others. Regardless of party, regardless of political, social or economic beliefs, right thinking individuals condemn the exemptions and are outspoken in favor of the President's proposal in connection therewith.

A recent Gallup survey [1] shows that 87 percent of the people say that people who work for the State and local governments should pay Federal income taxes on their salaries, and that 75 percent of the people state that people who own United States Government bonds or State or municipal bonds should have to pay Federal income taxes on their incomes from these securities. The large percentage in favor of such taxation is not confined to any income group. Even in the upper income group 69 percent are in favor of the removal of the exemptions.

That the effect of the existence of tax-exempt bonds upon the business life of the country is decidedly bad seems to be the view of the Twentieth Century Fund and of analysts generally.

So also, the newspapers of the country are consistent in their condemnation of the exemptions and their insistence upon their removal. In picking one out at random, I find the following:

TAX EVERYONE ALIKE

Certain Congressmen, while favoring the abolition of tax immunity for public employees and the holders of Government bonds, are of the opinion that a constitutional amendment is necessary in order to gain the objective.

However, the sixteenth amendment gives Congress the right to levy taxes on incomes "from whatever source," and surely that blanket proviso would seem sufficiently extensive without further changes in the fundamental law.

The sensible thing, at any rate, will be to pass the proposed law and leave final disposition of it in the hands of the United States Supreme Court. In the event of an adverse decision, the amendment machinery could be started with the loss of nothing but time.

The only mistake Congress could make in this connection would be that of failing to do anything about an inequitable situation that has long called for rectification in the interest of fiscal fairness.[2]

The caustic criticism of columnists in general is probably best exemplified by that of Westbrook Pegler in his column which appeared

[1] New York Times, February 8, 1939.
[2] Trenton Evening Times, February 3, 1939.

in the Washington Post of June 3, 1938, entitled "Charity Towards Some."

Many other columns and comments may be cited to you, but I will not protract this phase of the discussion.

Before going into methodology, it seems to me that, although in the case of bond interest taxation might increase slightly the cost of municipal and State bond financing, the ultimate benefits that would flow from such taxation should lead the States to look with favor upon the proposal, if they took an enlightened attitude. A surface examination does not readily reveal this, and, therefore, some State representatives are disposed to oppose the program. At this point I merely wish to state categorically that much of the statistical information presented to you last week is based upon misconceptions and a failure adequately to see and grasp the entire problem in its unrestricted scope.

Some may say that, while the end sought is good, the method proposed is not, because, under existing constitutional limitations, nothing can be done.

No one can criticise those who have an honest conviction to this effect. But we generally find that those who say this are the ones who do not wish to have anything done and use the Constitution as an excuse.

I feel confident in saying that no lawyer, known for his erudition, would state categorically that the law as to intergovernmental tax immunity is definitely one way or the other. In the light of recent cases, no more than a slightly informed guess may be ventured by anyone.

I am in sympathy with any method, including constitutional amendment, which would accomplish the desired result. We have had much experience, however, in attempting to procure results through constitutional amendment. We know only too well the many pitfalls, the delays, and the uncertainty attendant upon the submission and ratification of an amendment.

Senator AUSTIN. Have you studied that question of amendment?

Mr. GUTKIN. Yes.

Senator AUSTIN. As to how long it takes to get an amendment through?

Mr. GUTKIN. Yes.

Senator AUSTIN. And you know what the record is in this Congress about that?

Mr. GUTKIN. Well, I would——

Senator AUSTIN. Do you?

Mr. GUTKIN. I think I have some ideas in that connection.

Senator AUSTIN. As to time?

Mr. GUTKIN. I think so.

Senator AUSTIN. What is the average time that it takes to put through a constitutional amendment, according to our past history?

Mr. GUTKIN. I am not able to state the average time, but I know that in some instances some amendments have been put through only after many years, while others have not been put through at all.

Senator AUSTIN. You are speaking of the whole field of the amendments of the Constitution, in this statement, which seems to me to be contrary to the record.

Mr. GUTKIN. If you have some specific question, I will be glad to answer it.

Senator AUSTIN. In the Court controversy, and with reference to the Court-packing bill, that record was made perfectly obvious. Do you know what it was?

Mr. GUTKIN. I do not recall; although my next remarks are addressed to what you have in mind.

Senator AUSTIN. All right. We will pass on.

Mr. GUTKIN. Walter Lippmann, writing in his column in the New York Herald Tribune, says:

> President Roosevelt has proposed to overcome this difficulty by enacting a Federal statute ending the immunity for the future, and letting the Supreme Court say whether the old precedents stand or whether the Constitution can be reinterpreted. The President's suggestion is not, as some commentators have suggested, another attack on the judiciary and on constitutional principle. In spite of the decisions there is a real doubt about the whole matter. The Constitution is silent about it and it would be entirely proper for Congress to ask the Court to reconsider the problem.

What, then, can be said with respect to efforts to provide for the situation by legislation? I shall review the authorities briefly, and indicate my interpretation of some of the more important cases.

The prohibition against taxation by State and Nation, each by the other, of State and National agencies and obligations, arises, not by virtue of any express constitutional provision, but is based upon the proposition "that the right of taxation may be so used in such cases as to destroy the instruments by which the Government proposes to effect its lawful purposes in the States."[3] This doctrine was first enunciated in *McCulloch* v. *Maryland*,[4] and has been reiterated in various connections ever since.

In *Collector* v. *Day*,[5] the first Supreme Court decision actually recognizing the principle that the Federal Government may not tax State instrumentalities, the specific question was whether the salary of a State judicial officer was subject to taxation under the National Revenue Act of March 2, 1867. The Court concluded that the Congress did not have power to impose a tax upon such compensation, reasoning from its earlier opinons.[6] The implied immunity, therefore, found to exist with respect to the Federal Government, was held to be applicable reciprocally to the States, and has been so considered ever since.

It is apparent, however, to a careful analyst that under these cases it is indicated that the Federal taxing power in relation to State instrumentalities may have a markedly wider scope than the taxing power of the States in relation to Federal instrumentalities.

McCulloch v. *Maryland* was founded on the idea of supremacy of the laws and instrumentalities of the United States over State action, rather than on the idea of reciprocal immunity. Thus, 50 years later, the Court, in *Collector* v. *Day*, made a sharp and unwarranted departure from the earlier cases in holding the tax immunity to be reciprocal.

It is interesting, in this connection, to speculate upon whether the idea of reciprocal immunity, enunciated in *Collector* v. *Day* in 1871 and repeated through the years, may, although not warranted by *McCulloch* v. *Maryland*, not have been attributable and appropriate to the times.

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[3] *National Bank* v. *Commonwealth* (1869), 9 Wall. (76 U. S.) 353, 361.
[4] (1819) 4 Wheat. (17 U. S.), 316.
[5] (1870) 11 Wall. (78 U. S.) 113.
[6] *McCullough* v. *Maryland*, supra note 4; *Dobbins* v. *Commissioner*, (1842) 16 Peters (41 U. S.) 435; *Weston* v. *Charleston* (1829), 2 Peters (27 U. S.) 449.

A war had just settled any doubts about the final answer in a conflict which threatened the existence of the Union. Were political forces prepared for a nationalism which would permit Federal taxation of State instrumentalities and deny State taxation of Federal instrumentalities? It was Marshall's role to speak in terms of a firm nationalism, but the troublesome problem which several times was the occasion for his speeches was the problem of protecting the Federal Government against encroachments by the States, rather than the justification of encroachment by the Federal Government upon the functioning of the States. When considered in relation to their proper background, it is possible that Marshall's utterances, and also the doctrine of reciprocal immunity, were attributable to the stage of political development at the times they were spoken.

It may be suggested that the doctrine of reciprocal immunity is validly subject to criticism either because it was erroneously conceived or because of the way it has been applied, and not because it was out of tune with the times. *Collector* v. *Day* and a number of subsequent cases misapplied the doctrine and struck down taxes which were not discriminatory and which could not properly be said to hinder the operations of the States or the Federal Government.

Previous material presented to this committee has made a splendid analysis of the decisions on immunities in fields analogous to the immunity of the interest from Government bonds, and has shown how the rule of immunity has been made to yield to the rule of nondiscriminatory taxation. It has demonstrated how the Court has now rejected the premise of the Pollock decision,[7] that a tax on the income of bonds is the equivalent of a tax on the bonds themselves.

It has shown how, subsequent to the *Pollock case*, the Court appears to have reached a contradictory or inconsistent result with respect to other claims of immunity.

Thus, it has sustained franchise taxes which have reached the income from Government bonds by including such income in the measure of the franchise tax; it has approved the income taxation of the compensation of Government contractors, Government lessess, and Government employees; it has approved the taxation of net income from interstate commerce and the taxation of net income from exportation.[8]

When these healthy departures from what might have been an intolerable rigidity of rules of immunity are subjected to close analysis the inconsistency of continuing an immunity from income taxation of interest on Government bonds or officeholders stands out clearly. It seems proper to say that, while the developments in this field present a picture of inconsistency, they may have some justification, but only in a policy of experimentation and in a policy which emphasizes the rule of "some but not too much."

It can aptly be pointed out that, just as in the case of the Government contractor, the only relation which the Government bondholder has with the Government is that of contract; that one pays money to the Government and receives a promise to pay the agreed interest and to repay the principal, and that the other either transfers goods to the Government or performs services for it, or both, in return

[7] *Pollock* v. *Farmers Loan & Trust Co.*, (1895) 157 U. S. 429.

[8] See *Flint* v. *Stone Tracy Co.* (1911) 220 U. S. 107; *James* v. *Dravo Contracting Company*, (1937) 302 U. S. 134; *Helvering* v. *Mountain Producers*, (1938) 58 S. Ct. 623; *Greiner* v. *Lewellyn*, (1922) 258 U. S. 384; *Willcuts* v. *Bunn*, 1931) 282 U. S. 216; *Denman* v. *Slayton*, (1934) 287 U. S. 514; *United States Trust Co. of N. Y.* v. *Anderson* (C. C. A. 2d. 1933) 65 F (2d) 575 cert. den. 290 U. S. 683; *Peck & Co* v. *Lowe*, (1918) 247 U. S. 165.

for a promise to make the agreed payments, and that, as the Court permits the income of the contractor to be taxed, it is difficult to draw a distinction which would justify immunity of the bondholder.

In like manner, it can be pointed out that interest from Government bonds is reached by taxation, whether the tax is a franchise tax measured by income, or whether it is a tax upon income. From a philosophical approach, the only justification for the difference is that the Court, while not being willing to plunge the whole way for the removal of immunities, has endeavored to cut down the immunities, although such a process has resulted in distinctions which, when considered apart from this empirical process of Government, seem to be without substance.

Of particular interest and importance in connection with this problem is the history of the sixteenth amendment, which shows the agitation for the income tax, the congressional history of the amendment and the history of the ratification of the amendment.

The Department of Justice's study which has been given to you makes an outstanding contribution in this respect. The study demonstrates that the basic idea behind the movement for the income tax was that the Federal revenue system, heavily weighted with consumption taxes and so greatly at variance with the principle of ability to pay, should be modified by the introduction of an income tax which would permit wealth to pay taxes according to its ability.

> The movement was as broad as its subject and the evils sought to be remedied. There was no exception, exemption, or limitation, express or implied. The object was to impose a portion of the tax burden on the income from "wealth" or invested capital. There was no suggestion that any type of income should be considered immune.

It is ironical that some of the leading friends of the income tax should have interpreted the proposed amendment in a way that would, to an extent, defeat the purpose of income taxation. A long fight had been made for the income tax, the amendment had been submitted for ratification, and then an argument was advanced which raised fears that the amendment might not be ratified. Persons who had fought for the tax were fearful lest the argument result in sidetracking the amendment.

It was unfortunate that the argument was brought forward. Had the discussion not been precipitated, with the resulting interpretation by some active leaders that the amendment would not authorize taxation of the interest from State and local bonds, it seems reasonable to believe that the Court would have given full meaning to the plain words of the amendment.

The Department of Justice's study should perform a valuable service in bringing to the attention of the Congress and the Court a more complete view of the discussion relative to the intended scope of the amendment, which shows a preponderant understanding that power was being conferred to tax interest from State and local bonds and the salaries of State and municipal officers.

Directing our attention to the judicial aspect of the problem, the answer to the query as to whether or not the Court will reexamine its previous decisions based upon the doctrine of immunities may be found in other cases and the presence here of the factors which impelled reexamination in such cases. These cases indicate that the Court feels no hesitancy in reversing itself where conditions so warrant.

The Court plainly admits it is not infallible; plainly admits that judicial doctrine needs overhauling from time to time as political, sociological and economic trends change. In the past 8 years, the Court has overruled 10 of its previous decisions, containing at least six of its weighty doctrines.[9] Previous decisions have not been stumbling blocks to the Court where the end presently sought is contrary to such decisions.

The elements which led to restatement in recent cases are also clearly present when we come to consider the doctrine of implied immunities. Despite individual views as to the merits of a change, we have witnessed a gradual but sure metamorphosis in the relations between the Nation and the States. The Federal Government has been called upon to guide, finance, and manage the economic well-being of the people.

In the light of the intervening political, social, and economic changes which have taken place in the 119 years since the doctrine was recognized; in view of the experience we have had in applying the doctrine; in the light of the political and social defects of the doctrine viewed against the background of modern events; in the light of the mischievous results it has produced; in the light of the resulting clear and unjustifiable discrimination between citizen and citizen with respect to the tax burden required to be borne, it would seem that the Court should find grounds upon which to base a reexamination of the field of tax immunity, when called upon to pass upon fair, nondiscriminatory legislation. If the doctrine, upon reexamination, is clarified in a manner upholding the constitutionality of that legislation, the administration of the revenue laws of the Nation and the States will be simplified, and the burden of taxes as between persons similarly situated will become more uniform and just.

There are sound reasons to lead one to anticipate, if the legislation proposed is enacted, that the Court will actually reexamine. By casual remarks in its decisions, the Court has frequently indicated its willingness to reexamine certain of its previously established doctrines prior to their actual presentation for reconsideration. That seems definitely to be the case in connection with the doctrine of implied immunities.[10]

In connection with an analysis of the case material, it may be interesting to note the following additional comments. At the time *McCulloch* v. *Maryland* was decided, the fourteenth amendment was not as yet a part of the Federal Constitution. That instrument, therefore, contained no definite check on the arbitrary exercise of the taxing power by a State.

So, also, at that time, there was no express constitutional prohibition against States discriminating as between persons or subjects in their taxation. Since that time, the fourteenth amendment has been interpreted to provide such a check. It may thus be well, if the question is presented again, to reexamine, in the light of the fourteenth amendment, the theory upon which this case was founded, although

[9] *Fox Film Corporation* v. *Doyal* (1932) 286 U. S. 123), overruling *Long* v. *Rockwood* ((1928) 277 U. S. 142); *Chicago & E. I. R. Co.* v. *Commissioner* ((1932) 284 U. S. 297), overruling *Erie Railroad* v. *Collins* ((1920) 253 U. S. 77), and *Erie Railroad* v. *Szary* ((1920) 253 U. S. 86); *Funk* v. *U. S.* ((1933) 290 U. S. 371) overruling *Hendrix* v. *U. S.* ((1911) 219 U. S. 79) and *Jim Fuey Moy* v. *U. S.* ((1920) 254 U. S. 189); *West Coast Hotel Co.* v. *Parrish* ((1937) 300 U. S. 379) overruling *Adkins* v. *Children's Hospital* ((1923) 261 U. S. 525); *Helvering* v. *Mountain Producers Corporation* ((1938) 58 S. Ct. 623), overruling *Gillespie* v. *Oklahoma* ((1922) 257 U. S. 501) and *Burnet* v. *Coronado Oil & Gas Co.* ((1932) 285 U. S. 393); *Erie Railroad Co.* v. *Tompkins* ((1938) 304 U. S. 64), overruling *Swift* v. *Tyson* ((1842) 16 Pet. 1).

[10] *Brush* v. *Commissioner* ((1938), 300 U. S. 352); *Helvering* v. *Gerhardt* ((1938), 304 U. S. 405); rehearing denied (59 S. Ct. 57).

under the legislation proposed, it is not necessary to reexamine the *McCulloch case*.

It is apparent that this power to destroy by taxation and to discriminate between persons or subjects was not and is not possessed by the Federal Government.

Thus, the principle expounded by *McCulloch* v. *Maryland* was improperly and inaptly applied in *Collector* v. *Day*. The conclusion there is faulty, since the premise upon which it was based—that the power of the Federal Government to tax involved the power to destroy the States—was not and is not true.

It is conceivable that if Chief Justice Marshall had been convinced that the Federal Constitution contained a definite check on the arbitrary exercise of the taxing power by a State, a check such as the fourteenth amendment has been interpreted to provide, he might have believed less in the destructive force of the taxing power. Be that as it may, it is not necessary to demonstrate that the decision in *McCulloch* v. *Maryland* was either wise or unwise.

But, after all of this theorizing, what is the Supreme Court apt to do? The best case to which we may look for the purpose of prognosticating a result is the *Gerhardt case*.[11]

The *Gerhardt case* involved the constitutionality of a Federal income tax upon the salaries of certain employees—a construction engineer, and two assistant general managers—of the Port of New York Authority, a bi-State corporation created by compact between New York and New Jersey approved by Congress.

The corporation operated bridges, tunnels, an interstate bus line, and a freight terminal. These employees took oaths of office, although neither the compact nor the related statutes appear to have created any office to which they were appointed.

After reviewing and analyzing the authorities, the Court held that the imposition of the Federal income tax on such salaries was valid. The grounds, stated in the opinion of Mr. Justice Stone, and concurred in by three other Justices, were: That the tax was laid on net income derived from employment in common occupations not shown to be different in their methods or duties from those of similar employees in private industry, and thus was a nondiscriminatory tax laid on the net incomes of such employees in common with that of all other members of the community; that, as such, the tax could by no reasonable probability be considered to preclude the performance of the functions which New York and New Jersey have undertaken, or to obstruct them more than like private enterprises are obstructed by our taxing system; that the tax does not curtail any of those functions which have hitherto been thought to be essential to the continued existence of New York and New Jersey as States; that the burden of the tax affecting the States, as it does, only to the extent, if any, to which the employees pass it on to the States, does not give rise to an immunity from taxation because the actual burden on the State is so speculative and uncertain that immunity, if granted, would restrict the Federal taxing power without affording any corresponding tangible protection to the State governments.

Mr. Justice Black concurred separately, basing his opinion on a restatement and abrogation of the immunity doctrine, and also on the proposition that the sixteenth amendment, in authorizing the

[11] Supra, note 9.

taxation of income "from whatever source derived," justified the tax.

Justices Butler and McReynolds dissented on the ground that the taxation was constitutionally prohibited and said that the majority opinion had overruled a century of precedents.

The opinion of Mr. Justice Stone, after stating these grounds for its decision, undermined their value as positive guides for the future by stating, in further support of the decision, that employees of the port authority are not employees of a State or a political subdivision thereof within the meaning of the original applicable Treasury regulation.

While the holding in this case may be restricted to the point that the taxpayers involved were not considered to be officers or employees of a State, nevertheless, the language of the decision may be taken to indicate that a contrary result would be reached in the event the *Brush case* were to be litigated again. The decision is negative in effect, in that it indicates that no exemption exists with respect to the compensation of an officer or employee of a State if such officer or employee is not engaged in a function which has hitherto been thought to be essential to the continued existence of the State. Query as to those officers or employees who are so engaged?

Collector v. *Day*, while not overruled by the decision, is not specifically recognized as an authority.

The Court said, however, that since that case involved a State judicial officer, it was narrowly limited to a function which pertained to State governments at the time the Constitution was adopted, without which no State could long preserve its existence.

Regardless of opinions as to the actual effect of the decision on previous doctrines, it would seem to presage a holding, in a case adequately raising and arguing the issue, that officers of States and their political subdivisions not performing legislative, executive, or judicial functions, and having counterparts in private employment, are not immune from Federal taxation; and the possibility that officers performing such functions may be held to be taxable.

On all points, the opinion leaves the matter open for whatever action the Court may subsequently decide to take.

It furnishes no reason, however, to believe that *McCulloch* v. *Maryland* will be abrogated, although this point too is left open, for the Court definitely recognized a distinction between the immunity of the States and the immunity of the Nation, and illustrated the distinction by use of the original language of Marshall in *McCulloch* v. *Maryland.* So, also, the Court is silent as to what it may do with respect to the taxation of interest from State and local obligations.

We must conclude from this analysis that we cannot say with any degree of definiteness just what the Court is apt to do. I submit, however, that in view of the present state of the law, and the presumption of constitutionality of an act of Congress, legislation along the proposed lines is amply justified.

I have one further comment with respect to the *Gerhardt case*, as concerns its retroactive effect. The opinion is of immediate concern to officers and employees of States and their political subdivisions and instrumentalities.

Except insofar as prior decisions are res adjudicata in a technical sense, or as the statute of limitation may be applicable, tax deficiencies would seem to exist with respect to compensation received in past years by persons in governmental employments who were not engaged in performing functions essential to the continued existence of States, as States. Even the statute of limitation would provide no bar as to those who have not filed returns. While it would now be close to ruinous in many instances to open up past years during which these persons were lulled into a sense of security by virtue of what they then properly assumed to be the law, nevertheless it would seem to be the duty of the Treasury to effect collection of these deficiencies. It is thus incumbent upon the Congress to define the policy which the Treasury Department should apply with respect to this subject, and it is submitted that it should enact legislation which would eliminate the retroactive effect of this decision.

But should this committee conclude not to recommend the legislation proposed because of supposed constitutional grounds, there is, among others, still another method that is available, the constitutionality of which seems unassailable. In this connection, I refer to my paper which appeared in the July 1938 issue of the California Law Review, pages 579 601, with particular attention being paid to the part thereof which begins on page 594.

In 1919, Carter Glass, then Secretary of the Treasury, stated [12] that in connection with the practice of persons of wealth placing their funds in billions of dollars of wholly-exempt securities there was an—

> * * * urgent necessity of revision of the revenue law so as to require that, for the purpose of ascertaining the amount of surtax payable by a taxpayer, his income from State and municipal bonds shall be reported and included in his total income, and the portion of his income which is subject to taxation taxed at the rates specified in the act in respect to a total income of such amount. The Treasury's recommendations in this respect have been transmitted to the appropriate committees of Congress in connection with the Revenue Act of 1918, and again in the present calendar year. Under the present law a person having an income of, say, $1,000,000 from taxable securities would, upon the sale of half his property and the investment of the proceeds of that half in State or municipal bonds, not only obtain exemption for the income derived from such investment in State and municipal bonds, but greatly reduce the surtaxes payable in respect to his other income. It is intolerable that taxpayers should be allowed, by purchase of exempt securities, not only to obtain exemption with respect to the income derived therefrom but to reduce the supertaxes upon their other income, and to have the supertaxes upon their other income determined upon the assumption, contrary to fact, that they are not in possession of income derived from State and municipal bonds.
>
> A question has been raised concerning the right of the Federal Government under the Constitution to tax the income from State and municipal bonds, but there can be no doubt of the constitutionality of such an administrative provision. The proposal is not to tax the income derived from State and municipal securities, but to prevent evasion of the tax in respect to other income. The principles involved are abundantly established in the decisions of the Supreme Court sustaining taxes upon corporations, bank stock, etc. computed after taking into account income derived from Government, State, and municipal bonds.

Carter Glass' suggestion in this regard was not carried out. Thus, his optimistic statement that "there can be no doubt of the constitutionality of such an administrative provision" has never been put to the test.

Tax immunity results in surtax being eliminated at the highest rates, when considered with respect to a taxpayer's total income, both taxable and otherwise. What of legislation doing the converse namely, giving effect to the tax-exempt character of any income by applying to it the lowest surtax rates, rather than the highest, as at present? The tax would be imposed upon the taxable income, but

[12] Treasury, Annual Reports, 1919, Finance, pp. 24-25.

would be computed in the first instance upon the entire income, taxable or otherwise, immunity being accorded to the tax-exempt income by subtracting from the tax so computed an amount of tax which would be imposed with respect to the tax-exempt income computed as if that were the taxable income.

As an alternative to this method, query as to the validity of a statute using tax-exempt income along with taxable income for the purpose of ascertaining the average surtax rate, but applying such rate only to taxable income? Thereunder, a tax would be determined with respect to the total amount of the taxpayer's income, taxable or otherwise, and such proportion thereof would be paid as the amount of the taxable income would bear to such total income.

As to either or both of these methods, argument may only be made from analogy with cases such as *Maxwell* v. *Bugbee*,[13] and *Great Atlantic & Pacific Tea Co.* v. *Grosjean*,[14] to be contrasted with *National Life Insurance Co.* v. *United States*[15], *Missouri* v. *Gehner*,[16] *Miller* v. *Milwaukee*,[17] and *Schuylkill Trust Co.* v. *Pennsylvania*.[18]

In *Maxwell* v. *Bugbee* the Court upheld the validity of taxes imposed by the State of New Jersey upon the taxable estates of nonresident decedents, computed under a statute providing that the tax should bear the same ratio to the entire tax to which the estate would have been subject had the nonresident decedent been a resident of the State and had all his property been located in the State, as the taxable property in the State bore to the entire estate wherever situated. The rate of tax was graduated in accordance with the amount of property transferred.

The thing complained of was that the apportionment formula fixed by the statute resulted in a greater tax on the transfer of property of estates subject to the jurisdiction of New Jersey than would be assessed for the transfer of an equal amount, in a similar manner, of property of a decedent who died a resident of New Jersey.

In *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, the Court was concerned with a Louisiana statute which imposed a graduated scale of occupation or license taxes upon chain stores. The rates increased progressively so that for each store within the State which was part of a chain of more than 500 stores, wherever located, the tax was $550. In upholding the statute the Court said:

> The measure of the exaction is the number of units of the chain within the State—a measure sanctioned by our decisions. The rate of tax for each such unit is fixed by reference to the size of the entire chain. In legal contemplation the State does not lay a tax upon property lying beyond her borders nor does she tax any privilege exercised and enjoyed by the taxpayer in other States. We cannot hold that this privilege is unaffected by the status of the Louisiana stores as members of such a chain or that recognition of the advantages and capacities enjoyed by them as a result of that membership is forbidden in classifying them for progressive measure in rate.

The *Bugbee* and *Grosjean cases* open up new vistas in the field of taxation. While everything heretofore forbidden by reason of con-

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[13] (1919) 250 U. S. 525. Note (1937) 37 Col. L. Rev. 1231, 1233. *Cf. Frick* v. *Pennsylvania*, (1925) 268 U. S. 473.

[14] (1937) 301 U. S. 412. See Notes (1938) 38 Col. L. Rev. 1396; (1937) 37 Col. L. Rev. 1231, 1234. See also *Society for Savings* v. *Coite*, (1868) 73 U. S. (6 Wall.) 594; *Provident Institution* v. *Massachusetts*, (1868) 73 U. S. (6 Wall.) 611; *Hamilton Co.* v. *Massachusetts*, (1868) 73 U. S. (6 Wall) 632; *Home Insurance Co.* v. *New York*, (1890) 134 U. S. 594; *Educational Films Corp.* v. *Ward*, (1931) 282 U. S. 379; *Pacific Co.* v. *Johnson*, (1932) 285 U. S. 480; *Flint* v. *Stone Tracy*, (1911) 220 U. S. 107; *New York ex rel. Northern Finance Corp.* v. *Lynch*, (1933) 290 U. S. 601. A recent case in accord with the *Bugbee* and *Grosjean cases* is in re: *Lajtrgren's Estate*, (1937) 276 N. Y. 184, 11 N. E. (2d) 722.

[15] (1928) 277 U. S. 508.

[16] (1930) 281 U. S. 313. See (1930) 19 Geo. L. J. 119.

[17] (1927) 272 U. S. 713; (1927) 40 Harv. L. Rev. 790.

[18] (1935) 296 U. S. 113; (1936) 49 Harv. L. Rev. 480.

stitutional provisions may possibly not be accomplished by utilizing the formula and theory of these cases, nevertheless they recognize powers with which one must reckon. Their results are happy, since they give effect to a theory of taxation measured by ability to pay. Tax immunity does violence to this theory.

Current opinion, generally, seems to be that the rule of tax immunity hurts and that the greatest good for the greater number calls for the abrogation of the doctrine. Is it not, therefore, reasonable to suppose that the Supreme Court also holds this opinion?

Do not recent decisions show that the Court is attempting to keep abreast of the times? Is it not more than ever cognizant of changes demanded by a newly developing economic, social and political order? Accordingly, a method whereby the end sought would be acomplished without abrogating precedent would probably be sustained.

Cooley [19] lists three so-called "inherent limitations on the power to tax:"

(1) The want of power to tax for private purposes;
(2) The want of power of a State to tax Federal agencies and the want of power of the United States to tax State agencies; and
(3) The want of power to tax property outside the territorial limits.

Immunity from taxation and lack of jurisdiction—is not the third mentioned limitation a greater restriction on the exercise of power than the second?

The lack of jurisdiction over a subject matter has in all fields of law rendered action with relation thereto absolutely void. Yet, are not these two analogous to a great extent? The one is to preserve the separate and sovereign nature of the Government, the other is to preserve the individual from the repetition of taxation by many sovereigns, and both involve the power to destroy by taxation. Therefore, from a legalistic approach, *Maxwell* v. *Bugbee* provides a rather compelling analogy. This case is ably analyzed and discussed by Professor Lowndes,[20] and there is little to add to his discussion thereof.

That at least one of the methods of taxation here suggested would fit into the formula of that case is evident. That the formula would be held to be applicable coextensively to tax immunity as it was to jurisdiction can be answered by referring again to the desirability of arriving at such a result. The philosophical considerations necessary to carry over the method there availed of to the field of tax immunity are present.

A serious question arises in connection with the formula.

The tax in *Maxwell* v. *Bugbee* lends itself to the following analysis: The tax imposed equaled the tax computed with respect to all property of the decedent, entire estate, and multiplied by a fraction, of which the property in the jurisdiction was the numerator and the entire estate was the denominator. Stated differently, the rate of tax was determined by dividing the tax computed with respect to the entire estate by the amount of such entire estate, producing an average rate.

In *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, however, the statute under consideration provided for a graduated scale of taxes depending upon the number of stores owned by the taxpayer in all jurisdictions, the rate being applied with respect to the number of stores within the jurisdiction—Louisiana. The rate thus imposed

[19] 1 Cooley, Taxation (4th ed. 1924), sec. 86.
[20] Lowndes, Rate and Measure in Jurisdiction to Tax-Aftermath of Maxwell v. Bugbee (1936), 49 Harv. L. Rev. 756.

was not an average rate, as in the *Maxwell* v. *Bugbee* situation, but was the top rate. The statute was held not to violate the due process clause, since only the rate of the tax, and not its subject or measure, included extraterritorial factors.

As to whether one of the two alternative methods suggested would be upheld and the other rejected, little more than a conditioned guess may be ventured. That the method patterned after the *Maxwell* v. *Bugbee* formula would, has already been asserted.

That the other would not cannot be asserted. The *Maxwell* v. *Bugbee* method recommends itself as affording the opportunity for a stronger case. The legislative power to fix any desired rate with respect to taxable income has not been denied. Mathematically, the *Maxwell* v. *Bugbee* plan supplies a rate. *Frick* v. *Pennsylvania*,[21] so analyzes it. The conclusion follows.

Does the other method bring the exempt income into the measure of the tax? While *Great Atlantic & Pacific Tea Co.* v. *Grosjean* upheld taking the top rate, it cannot be analyzed as providing for an exemption with respect to a nontaxable at a different and lower average rate than that which is applied to the taxable property.

The first of the above-mentioned methods would seem to provide for the entry of nontaxable income directly into the computation of the surtax. While it may well be upheld by the Court, out of a desire to adopt anything not specifically prohibited by precedent, it might be best to creep before attempting to walk, even though successful walking would lead to the destination more quickly.

Conceding that in both plans the exempt income goes into the measure of the tax to some degree, the plan patterned after the *Maxwell* v. *Bugbee* formula treats the nontaxable income in a manner uniform with the treatment accorded the taxable income. The other plan seems not to do so. Is not the latter thus akin to that which was struck down by the *National Life case*? [22]

It is submitted that if the treatment accorded tax-exempts by a proposed plan of taxation is uniform with the treatment accorded taxables, exemption being granted with relation to such tax-exempts in the same manner and upon the same basis as the taxables are taxed, the plan would probably be upheld.

In *National Life Insurance Co.* v. *United States*,[23] the Court held that a provision of the Revenue Act of 1921, abating a 4-percent deduction from gross income therein allowed by the amount of interest received from tax-exempt securities, was invalid, since Congress may not tax such securities by denying to their owners deductions allowed to others.

If the income of the taxpayer in that case had been entirely taxable, the tax would have amounted to the exact sum which was imposed by the invalidated provisions.

As stated in the opinion:

> Thus it becomes apparent that petitioner was accorded no advantage by reason of ownership of tax-exempt securities.[24]

[21] (1925) 268 U. S. 473.

[22] Since the decisions in the *National Life*, *Gehner* and *Schylkill Trust Co. cases*, the members of the Court who were then in the minority seem to have exchanged positions with the then majority. It may thus be that what is now conceived to be the majority would not feel impelled to follow these cases. Accordingly, both plans may well be held to be valid. To so hold would not be inconsistent with what is taken to be the earlier minority views, although such a result would probably be incongruous when viewed from the aspect of the majority in those earlier cases.

[23] Supra note 14.

[24] Ibid. at 519.

No more than this should have been said. Nevertheless, the language of the opinion is broad and presents a difficult hurdle.

> One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted * * *[25]

Said the Court.

In the light of subsequent cases, however, the most that should properly be ascribed to the *National Life case* is that in taxing income part of which is tax-exempt, the presence of exempt income cannot be made the basis for denying to the taxpayer benefits enjoyed by taxable income, and that no discrimination may be practiced with relation to the exempt portion. In other words, deductions cannot be limited by reason of the presence of exempt income. And, so construed, the *National Life case*, as well as *Missouri* v. *Gehner*,[26] is not authority against the suggestion here made.

In the latter case, the State statute provided that in taxing an insurance company's assets, its legal reserves and unpaid policy claims should first be deducted from its total assets. The State supreme court construed the statute as requiring that the reserve and claims should be apportioned between the two classes of assets—taxable and nontaxable—and that the deduction should be in the proportion that the taxable assets bore to the total assets.

The Supreme Court reversed the judgment of the State court, holding that the statute as so construed was unconstitutional.

Justices Stone, Brandeis, and Holmes dissented.

Analysis indicates that the tax-exempt property entered directly into the measure of the tax there invalidated, as it did in the *National Life case*. In neither case was the exempt income or property used solely for the purpose of determining the rate of tax. In both a deduction was being denied, or lessened, because of the presence of tax exempts. The curtailment of the exemption, in effect, increased the amount being taxed and discriminated against tax exempts in favor of taxables, so far as concerned the allowance of deductions.

Again, in *Schuylkill Trust Co.* v. *Pennsylvania*,[27] the statute was construed to discriminate against tax exempts. The State statute provided for the valuation of shares of a trust company by adding together the amount of the paid-in capital, surplus, and undivided profits that was not invested in the stocks of corporations liable to pay—or specifically exempted from the payment of—capital stock tax, or a tax on shares, and by dividing this total amount by the number of outstanding shares of the company.

The taxpayer in question possessed bonds of the Federal Government, which the State revenue department included in the measure of the tax. The tax was levied on the shares as so valued, and, accordingly, was held to be invalid. Justices Cardozo, Brandeis, and Stone dissented.

Here, again, the exempt property entered into the amount subjected to tax. It was not used merely to affect the rate of tax. The utility of the case as authority in the field of tax exemption would seem to be in connection with statutory attempts to use, through indirection, exempt property or income in determining the measure of a tax.

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[25] Ibid.
[26] Supra, note 15.
[27] Supra, note 17.

As such it would fall into the same category as *Macallen Co.* v. *Massachusetts; Miller* v. *Milwaukee;* and others.[23]

To attempt to develop a theory on the basis of a distinction between rate and measure is not entirely satisfactory, if we are taking an informed view of what is being attempted. An increase in rate, where the taxpayer has exempt income, just as effectively increases the tax payable, as if the measure of the tax were increased and the rate remained the same. If we are thinking in such concepts as "not doing by indirection what cannot be done by direction," of course this proposal must fail.

But many cases, without as well as within the field of taxation, indicate that this, like other maxims, is but a convenient handle to grasp after a result is once reached.

From an economic and sociological aspect, experimentation looking toward the taxation of tax-immune income seems to be justified, provided that there is a sound theory upon which attempts to reach the end sought may be based. That there are such theories is illustrated by the foregoing discussion.

In conclusion, it is unnecessary to dwell upon the fact that maintenance of tax revenues is a matter of imperative importance to the States and the Nation. Similarly, it is unnecessary further to elaborate on the unfortunate consequences which flow from a division of competitors into taxable and tax-exempt classes. From such division there inevitably develop conditions of special advantage, dissatisfaction, and general lack of confidence in the equity of our taxingsystems. Prof. Walton H. Hamilton, of Yale University Law School, sums up the matter in a rather droll way. He says:

> Citizens of the United States are not to be deprived of their inherent right to contribute to the support of their Federal Government just because an unkind fate has made them officers of a State.

I add—or holders of State obligations.

Senator BYRD. We will now stand in recess until 10 a. m. tomorrow.

(Thereupon, at 12:55 p. m., the special committee recessed until the next day, Wednesday, February 15, 1939, at 10 a. m.)

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[23] In addition to the method here suggested, it seems possible, in the case of corporations, to circumvent the decisions by substituting an excise tax for the present income tax. As before noted, this method was held valid in *Flint* v. *Stone Tracy Co.* (1911) (220 U. S. 107). While *Macallen Co.* v. *Massachusetts* (1929) (279 U. S. 620), Traynor, National Bank Taxation in California (1929) (17 Calif. L. Rev. 456), standing by itself may be said to overrule the *Stone Tracy case* (see T. R. Powell, *The Macallen case* (1930) (8 Nat. Inc. Tax Mag. 47, 91)), and *Miller* v. *Milwaukee* (1927) (272 U. S. 713), to be an impediment because of the fact that the purpose would unquestionably be to reach tax-exempt income, nevertheless, in the light of *Educational Films Corporation* v. *Ward* (1931) (282 U. S. 379) (holding that a franchise tax measured by net income, including royalties from the use of copyrights, was valid), it would seem that the authority of the *Stone Tracy case* is once again established and the *Macallen case*, in effect, overruled. See (1931) (44 Harv. L. Rev. 820); T. R. Powell, An Imaginary Judicial Opinion (1931) (44 Harv. L. Rev. 889). This position was confirmed in *Pacific Co.* v. *Johnson* (1932) (285 U. S. 480).

Other interesting examples are: *Cohn* v. *Graves* (1937) (300 U. S. 308) (upholding taxation by New York of net income, consisting in part of rent from lands situate in New Jersey and interest on bonds secured by mortgage on lands situate outside of State); *Greiner* v. *Lewellyn* (1922) (258 U. S. 384) (securities of a State or political subdivision not exempt from national succession taxes); *Thompson* v. *Commissioner* (1929) (17 B. T. A. 987) (rent received by lessor from city of Baltimore for use of land for school purposes held not within the exemption accorded "interest" by Revenue Act of 1924); *Willcuts* v. *Bunn*, supra, note 8 (profits from sale of tax-exempt bonds held taxable since the tax imposed no burden on the State); *Denman* v. *Slayton* (1931) (282 U. S. 514) (interest on money borrowed to buy and carry bonds of a municipality held taxable); *United States Trust Company of New York* v. *Anderson* ((C. C. A. 2d, 1933) 65 F. (2d) 575, cert. den., 290 U. S. 683) (interest paid on a condemnation award held taxable). This method would seem to be usable either independently of, or as supplementary to, the proposal made in the latter half of this discussion. It is apparent that in the case of a corporation, the inclusion of exempt income for the purpose of ascertaining the tax rate is of little utility, since there is very little change from one bracket to another of the progressive rates of tax imposed with respect to corporations.

TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

WEDNESDAY, FEBRUARY 15, 1939

United States Senate,
Special Committee on the Taxation of
Governmental Securities and Salaries,
Washington, D. C.

The special committee met, pursuant to adjournment, 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.

As I understand, the Under Secretary of the Treasury will appear and make a statement.

Mr. Hanes. Yes, sir.

The Chairman. And Mr. Wenchel, do you expect to follow the Under Secretary?

Mr. Wenchel. Mr. Morris will follow.

Mr. Morris. That is what I understood to be the procedure.

The Chairman. Are they the only witnesses?

Mr. Hanes. We have some statistical records that we want to put in the record. Mr. Blough will make a statement, and Mr. Murphy and Mr. O'Donnell; may they have a few minutes?

The Chairman. Yes.

I just wanted to get the general plan of the hearings for the day.

Mr. Morris, will you have someone with you?

Mr. Morris. Yes. I think that we would like to have Mr. Gardner to supplement my statement, and Mr. Wenchel would like to follow.

The Chairman. I may say that there is no Senate session this afternoon, and I hope to conclude the hearings this afternoon, if possible.

Mr. Hanes. As to the order of procedure, it is perfectly all right to have Mr. Morris follow me.

The Chairman. It makes no difference.

I think that we should have your statement now, and, if the committee members have any questions, they may ask them. You may go right ahead.

STATEMENT OF HON. JOHN W. HANES, UNDER SECRETARY OF THE TREASURY

Mr. Hanes. May it please the chairman and gentlemen of the committee, in my earlier appearance before your committee I discussed the reasons why the Treasury Department favors the elimination of reciprocal exemptions of governmental interest and salaries. With regard to salaries, I called your attention to the fact that tax exemption sets up a specially privileged group of citizens who receive all the benefits of citizenship and are exempt from their fair share of the burdens of that citizenship.

With regard to tax-exempt interest on Government securities, I pointed out that such exemption results in serious inequities in the tax system because it provides a tax-free haven to persons in the higher income brackets who are able to secure much more benefit in lower taxes than they sacrifice through lower interest rates due to tax exemption; and because it accordingly necessitates persons with smaller incomes making up the revenue thus lost to the Government.

The CHAIRMAN. Do you agree that the number of persons who would gain by the ownership of tax-exempt securities are those who have incomes from $55,000 to $60,000 and up?

Mr. HANES. No, sir. Senator, we are going to discuss that in some detail.

The CHAIRMAN. Plus the statement, as I recall it, presented by Senator Townsend, that there were approximately 12,700 persons with incomes in excess of the figure I state?

Mr. HANES. We will discuss that also, and we will insert into the record the actual figures, as taken from the Bureau of Internal Revenue.

The CHAIRMAN. I hope you will make a general statement concerning it.

Mr. HANES. I think we will cover that point sufficiently well.

I also showed that, to the extent that interest rates are lower, due to tax exemption, public trust funds, savings institutions, educational and charitable endowments, persons in the lower income groups, and other investors to whom tax exemption means nothing, receive lower incomes than they otherwise would.

I pointed out, furthermore, that tax exemption of interest on governmental debt discourages investment in enterprise capital. I was careful in this connection to indicate that tax exemption is by no means the only obstacle to such investment but showed that it is an important one.

Since I appeared before your committee, it has heard a considerable number of persons opposed to the elimination of tax-exempt interest. So far as I am aware, little opposition has been expressed to the elimination of the tax exemption of salaries. Accordingly, it appears to be unnecessary for me to speak further on that subject.

With respect to tax-exempt interest, a great deal of objection has been raised, practically all of which has been directed to the questions of the revenue from, and the costs of, eliminating tax exemption. It should be observed that I specifically indicated in my earlier statement that I do not consider the revenue and cost aspects to be of the same magnitude of importance as the equitable and economic aspects. I am convinced that none of the testimony offered has in any way shaken the foundations of my position that tax exemption leads to inequities and discourages investment in enterprise capital.

However, since so much stress was placed by those opposing the elimination of tax exemption on the revenue and cost aspects, and since the figures presented to the committee were in many respects substantially at variance with those that the Treasury Department has found in its studies, it seems desirable for us to make some further observations.

With the committee's permission, I should like to present at this time members of the Treasury technical staff who will discuss various factual questions involved in the testimony presented to the committee. Mr. Blough will discuss the distribution of burdens and benefits among various governmental units and classes of people. Mr. Murphy will discuss the question of differentials in interest rates arising from tax exemption and the probable effects on interest rates of eliminating such exemptions. Mr. O'Donnell will discuss the question of revenues likely to be derived from eliminating tax exemption.

So, if the committee is willing, at this time I would like to have you hear from Mr. Blough, director of tax research.

The CHAIRMAN. Certainly.

STATEMENT OF ROY BLOUGH, DIRECTOR OF TAX RESEARCH, TREASURY DEPARTMENT

The CHAIRMAN. Mr. Blough, you may go ahead with your statement.

Mr. BLOUGH. Mr. Chairman and gentlemen of the committee; some very interesting and, no doubt, very impressive fiscal and economic arguments have been presented to the committee by those in opposition to eliminating the tax exemption of interest on future issues of governmental securities. The validity of these arguments depends on the correctness of the facts supporting them. We believe that some of the facts presented to the committee contain serious errors. It is my purpose to point out certain of the more significant of these errors, as well as to bring to the committee's attention certain other important facts that have been overlooked. We believe that the correct factual picture will reveal some of the arguments advanced against eliminating tax exemption to be groundless and others to be of little significance.

In his statement to this committee, made on January 18, Mr. Hanes pointed out that one of the most important evils of exempting the interest on governmental securities from taxation is its effect in nullifying the progressive income-tax system. Opponents of taxing governmental interest have contested this position. The most eleborate argument was made by Professor Lutz, who voiced three contentions.

First, that "the emphasis on progression and ability to pay" is being overstressed;

Second, that progressive taxation has already been departed from in the special taxation of capital gains and in the treatment of charitable contributions; and

Third, that not enough people stand to gain from the purchase of tax-exempt securities to make any resulting breach of the progressive income tax significant. The last bears on the point that you mentioned, Mr. Chairman.

With regard to the argument that too much emphasis is already given to progressive taxation, it must be agreed that this is fundamentally a matter of opinion. However, it has long been felt by most students of taxation that entirely too little emphasis has been placed on taxes that take into consideration the taxpaying ability of the individual. In the total Federal, State, and local tax system, yielding approximately $13,000,000,000, only 10 percent is derived from progressive taxes imposed on individual incomes.

The argument that Congress has already departed from the progressive principle in the taxation of capital gains and the allowance of deductions for charitable contributions overlooks certain facts. Capital gains are not subject to lower rates of taxation if they are derived from assets held for not more than 18 months.

It is only when assets are held for a period of years and the imposition of the regular scale of rates would place upon them an unreasonably high tax rate, considering the period of time over which the gain accrued, that lower rates are provided. Thus, one of the purposes of the special treatment of capital gains is to preserve and not to destroy the fair application of the progressive principle. In the case of gifts to charity, it should be noted that the individual does not receive the direct benefit of the income which he gives away. Accordingly, allowing such gifts as a deduction within limits is really an extension of the deductions from income of costs to the individual. Since the individual does not enjoy the direct use of the funds he has given, there is no abrogation of the progressive income tax principle.

To support the third argument, namely, that very few persons can gain from the purchase of tax-exempt securities, Professor Lutz introduced a table which purported to show that a person would need to have an income of about $60,000 before he would gain more in taxes saved than he sacrificed in a lower interest yield on tax-exempt securities. He stated that there are only about 13,000 people receiving incomes of that magnitude.

The committee will recall that the Under Secretary pointed out that anyone with a surtax net income of more than $18,000, which means a total net income of approximately $20,000, can derive a net tax advantage from buying tax-exempt securities and that in 1936 there were nearly 100,000 such persons.

There are two reasons for the disagreement between the figures presented by the Under Secretary and those presented by Professor Lutz. In part, it arises from differences in the interest differential assumed to result from tax exemption. This, however, explains only a minor part of the disagreement, because, even if the interest differential of six-tenths of 1 percent proposed by Professor Lutz is accepted, persons who have incomes of about $35,000 or over would stand to derive a net gain from tax exemption.

Senator AUSTIN. How do you account for the difference between Professor Lutz's statement and yours?

Mr. BLOUGH. I think that is taken up in the next paragraph, if I may read it.

The second and more important difference arises from unreasonable assumptions regarding individual incomes.

That is, in the $18,000 figure presented by the Under Secretary, a differential of substantially three-eighths of 1 percent, halfway between one-quarter and one-half, was accepted.

The second and more important difference arises from unreasonable assumptions regarding individual incomes.

The CHAIRMAN. Before you leave three-eighths and six-tenths percent, what figures do you have to support your figure as against Professor Lutz?

Mr. BLOUGH. If it please the committee, Mr. Murphy, who is coming after me, is going into that.

The CHAIRMAN. Very well.

Mr. BLOUGH. Professor Lutz, in referring to the total income of an individual, ignored the wholly tax-exempt income. In doing so, he eliminated an undetermined but probably quite substantial number of people who had incomes of considerable size, which they derived largely from tax-exempt securities.

More important, Professor Lutz based his computations on the assumption that an individual would derive either all or none of his income from tax-exempt securities.

However, a person would not ordinarily invest all of his capital in tax-exempt securities. He might be in position to gain by the purchase of only a small amount.

On the other hand, he would scarcely purchase them beyond the point where they brought him a net gain.

As previously indicated, this point is about $20,000 net income, if an interest differential of three-eighths of 1 percent is assumed, and about $35,000 if a differential of six-tenths of 1 percent is assumed.

To show the effects of investing various portions of one's capital in tax-exempt securities, we have prepared a table covering a number of income levels which we should like to have introduced into the record at this point.

Senator TOWNSEND. Have you any figures showing how many incomes there were in excess of $1,000,000?

Mr. BLOUGH. Yes, sir; the figures for 1936 are right here; a very small number—61.

Senator TOWNSEND. Then they have taken account of them with a million dollars income?

Mr. BLOUGH. Yes, sir.

It has been assumed that if the wholly tax-exempt interest they reported had been taxable, they would have received 15 percent more interest than they received under present conditions. This 15 percent was derived by taking a point halfway between the one-fourth percent differential and the one-half percent differential, and relating it to a tax-exempt interest rate of 2½ percent. In other words, it is three-eighths of 1 percent interest differential expressed as a percentage of a 2½ percent interest rate.

(The table referred to follows:)

EXHIBIT A. INDIVIDUAL INCOME TAX

Net income after tax under present law and net income after tax under a proposal that interest on Government obligations be made taxable, for selected levels of net income and according to the relation of interest on Government obligations to total selected net income [1]

NET INCOME AFTER TAX UNDER PRESENT LAW [2]

	Percent of selected net income received as interest on Government obligations					
	0 percent	10 percent	25 percent	50 percent	75 percent	100 percent
Selected net income, including interest on Government obligations:						
$5,000	$4,920	$4,940	$4,970	$5,000	$5,000	$5,000
$10,000	9,585	9,675	9,800	9,940	10,000	10,000
$20,000	18,411	18,701	19,076	19,601	19,956	20,000
$50,000	41,131	42,636	44,646	47,511	49,356	50,000
$100,000	67,531	73,331	81,221	91,131	97,511	100,000
$500,000	195,856	231,856	285,306	371,706	452,106	500,000
$1,000,000	320,956	396,956	510,906	695,856	871,706	1,000,000

[1] For a married man with no dependents.

[2] Assuming that the maximum earned income credit is taken, that no interest is received from partially tax-exempt Government obligations, that no capital gain or loss is sustained, and that, under the proposal, the interest yield on Government obligations will increase 15 percent.

Net income after tax under present law and net income after tax under a proposal that interest on Government obligations be made taxable, for selected levels of net income and according to the relation of interest on Government obligations to total selected net income.—Continued.

NET INCOME AFTER TAX UNDER THE PROPOSAL THAT INTEREST ON GOVERNMENT OBLIGATIONS BE MADE TAXABLE

	Percent of selected net income received as interest on Government obligations					
	0 percent	10 percent	25 percent	50 percent	75 percent	100 percent
Selected net income, including interest on Government obligations:						
$5,000	$4,920	$4,992	$5,100	$5,280	$5,460	$5,640
10,000	9,585	9,721	9,926	10,265	10,602	10,940
$20,000	18,411	18,666	19,043	19,666	20,288	20,901
$50,000	41,131	41,648	42,425	43,668	44,887	46,106
$100,000	67,531	68,146	69,031	70,456	71,881	73,306
$500,000	195,856	197,856	200,781	205,656	210,531	215,406
$1,000,000	320,956	324,431	329,006	337,231	346,856	355,481

RELATION OF NET INCOME AFTER TAX UNDER PRESENT LAW TO NET INCOME AFTER TAX UNDER THE PROPOSAL

Selected net income, including interest on Government obligations:	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
$5,000	100	98.96	97.45	91.70	91.58	88.65
$10,000	100	99.53	98.73	96.83	94.32	91.41
$20,000	100	100.19	100.17	99.67	98.30	95.69
$50,000	100	102.37	105.24	108.80	109.96	108.45
$100,000	100	107.61	117.66	120.34	135.66	136.41
$500,000	100	117.18	142.10	180.74	214.75	232.12
$1,000,000	100	122.35	155.01	206.34	251.32	281.31

Source: Treasury Department, Division of Tax Research.

The table shows clearly the advantage or disadvantage of investing various portions of one's assets in tax-exempt securities for persons at different levels of income. It shows that individuals with moderate-size incomes cannot now avail themselves of investments in public securities.

Senator TOWNSEND. You begin at $5,000?

Mr. BLOUGH. We begin at $5,000 and we go on up.

Now, if these men invested some money in tax-exempt securities, how much money would they have left? Take the first man, if he invested nothing in tax-exempts, he would have $4,920 left. But if he invested 50 percent in tax-exempts, he would have all of his $5,000 left. Take the first man with a million, he would have approximately——

The CHAIRMAN. That is after payment of the tax?

Mr. BLOUGH. That is after payment of the income tax.

Senator TOWNSEND. You say here, he would have three hundred and twenty-one thousand left. You mean by that that he pays the difference between the million dollars and this sum in tax?

Mr. BLOUGH. That is correct. The $679,000 would go in tax.

Senator TOWNSEND. Well, that does not bother me.

Mr. BLOUGH. Now, suppose he was getting 10 percent of his income from tax-exempt securities and 90 percent from other sources, in the case of the man with a $5,000 income, there is little change. In the case of the man with the million-dollar income, he would have $397,000 left. He would have made a substantial saving there.

The CHAIRMAN. A little over $70,000.

Mr. BLOUGH. Yes, sir. That does not represent exactly a net saving of this amount.

Next, we go over on across here, showing what the amount would be if he received 25 percent, 50 percent, 75 percent, and on to 100 percent of his income from tax-exempt securities.

Of course, if he had all of his income from tax-exempt securities, he would have all of it left, and there would be nothing paid in tax; that is, paying no attention to any interest differential. That is just assuming he received a certain portion of his income in tax-exempt securities.

Now, shall I go on to the second bank?

The CHAIRMAN. Yes. I think I have the first one.

Mr. BLOUGH. The second bank says: "Net income after tax under the proposal that interest on Government obligations be made taxable."

Now if interest from these tax-exempt public securities became taxable, we would have to give the men some additional interest, and we figured that interest at 15 percent more than he was getting. We are using the three-eighths differential on a fully tax-exempt security mentioned in connection with the first table. Mr. Murphy will explain how we arrived at that, and that is about 15 percent of the total interest from totally tax-exempt securities on the first table. We say, if these securities are all taxable, the man would receive some additional interest, and show that at 15 percent interest. Do I make myself clear?

The CHAIRMAN. You assume by that that there would be an average rise in cost to the State and local governments of 15 percent over and above the present interest rate that is charged on those securities?

Mr. BLOUGH. That is the basis on which this computation is made.

The CHAIRMAN. In other words, the 2 percent rate, you figure, would be 2.15?

Mr. BLOUGH. No; it would be 2.30.

There is some question as to whether that 15 percent should be applied to the 3 and 4 percent, but, to make our aggregate somewhere within the range of simplicity, we have applied that throughout.

Senator AUSTIN. Just a moment there. Now, is it correct to interpret that 15 percent in this way, under the proposal that the yield on Government obligations would increase 15 percent?

Mr. BLOUGH. That is the basis on which it is computed?

Senator AUSTIN. That is not 15 percent on the principal?

Mr. BLOUGH. No.

Senator TOWNSEND. From what experience do you arrive at that figure?

Mr. BLOUGH. I would prefer that you go into that with Mr. Murphy.

Senator TOWNSEND. I will not press that question.

The CHAIRMAN. We will assume that there will be a 15-percent increase in interest costs.

Mr. BLOUGH. Now, we have arranged it this way.

Senator BYRD. That applies equally to bonds of States and their subdivisions?

Mr. BLOUGH. Yes, sir.

Senator BYRD. Do you take into consideration the fact that some of the better securities are taxable now?

Mr. BLOUGH. We are dealing only with the wholly tax-exempt securities.

The CHAIRMAN. You recall that Dr. Lutz's statement was 60?

Mr. BLOUGH. That is right.

The CHAIRMAN. And the gentleman from New York put it at 75.

Mr. BLOUGH. Yes. We think that those are quite high, Senator.

The CHAIRMAN. That is not 60 percent?

Mr. BLOUGH. Sixty points, which comes around 25 percent increase in interest cost, instead of the 15 percent that we are using, and I might say, for this table, the larger the percent of increase in interest, the less saving the person in the higher income-tax bracket receives.

Senator BYRD. Have you taken into consideration this, that in some localities some of these bonds were issued 5 years ago, or 10 years ago, at a higher rate of interest than will probably occur when they are refunded?

Mr. BLOUGH. That is quite right.

Senator BYRD. I do not think you should give the impression there is going to be a 15 percent increase in all the interest rates, for some of these bonds may be refunded at a lower rate.

Mr. BLOUGH. We do not give that impression. We are trying to say under what circumstances a man realizes a net gain. Professor Lutz puts that at about 60 points, and the other gentleman put it at about 75.

Senator BYRD. Have you a study of local bonds that may have been issued some time ago, giving the rate of interest upon the bonds now paid?

Mr. BLOUGH. We have made some study.

Senator BYRD. Do you not know that if they should be refunded at the time of their maturity it is possible that they may be sold at very much lower rates than now exist?

Mr. BLOUGH. We are quite sure of that. As a matter of fact, I mentioned that bonds issued in 1929 were issued for a much higher interest rate.

Senator BYRD. Have you gone into that fully, and taken the localities and the maturities and given the present interest rate that they are now paying? For instance, I know, in Virginia, there were bonds issued 5 and 10 years ago at very much higher interest rates than they can be refunded for now.

Mr. MURPHY. We do not have the figures in that form, but our estimates of the aggregate increase in interest cost for both the Federal and the States and local governments are based on the present yields, rather than the yields at the time the securities were issued.

Senator BYRD. I think you should further give consideration to the fact of the approved supervision of local bonds under State agencies is going to mean that these bonds can be sold at a lower interest rate than in the past, the fact that the States are making provision to require the payment of the interest when it becomes due, when the locality itself passed the interest by.

Mr. BLOUGH. We have taken that into consideration, and we feel and we consider that point in favor of the position taken by the Treasury.

Senator BYRD. I see it is in your favor, but I do not think the impression should get abroad that there is going to be a uniform 15 percent increase over what is now being paid. I think it will be, as a matter of fact, less in some securities.

Mr. BLOUGH. We think so too, but we see how this would work out in the various brackets.

Now, you take the next bank, which would show how much income the taxpayer with a certain percent of income from Government obligations would have left after paying the tax, and you will notice that the man with the million-dollar income who has income only from Government obligations has only $355,000 left, with the 15 percent average increase in the rate, instead of the million dollars he has left under the present law.

You see, that under the proposal if he had all Government securities this would leave him with only a little over one-third of the income he now has, that is, if he received all of his income from tax-exempt obligations.

Senator BYRD. The Federal Government is roughly paying now $1,050,000,000 interest. What percent of those obligations is there surtax on?

Mr. BLOUGH. Of the $36,579,000,000 United States Government's securities, outstanding on June 30, 1938, $13,492,000,000 were wholly exempt, and $23,087,000,000 were partially exempt.

Senator BYRD. Your estimate of increase of 15 percent applies to the totally exempt securities?

Mr. BLOUGH. That is correct.

Senator BYRD. If you assume that they are all totally exempt, there would be a possible $150,000,000 increase in the interest—based on the present interest of about one billion dollars in interest?

Mr. BLOUGH. We do not think that the increase would be anything like that amount, because most of them are already subject to the surtax.

Senator BYRD. What you say is that if you take all of the totally exempt securities now, that there would be an increased cost of 15 percent in the interest payments?

Mr. BLOUGH. But, in this particular table we are dealing with the other end, with the man who is getting it. So far as the Government is concerned, that increased cost we have placed at a range of one-fourth of 1 percent to one-half of 1 percent, and we take the figure in between there, three-eighths of 1 percent, on interest, and that three-eighths of 1 percent would amount to about 15 percent of the rate on the best fully tax-exempt securities; that is, it is about 15 percent of 2.5 percent, which is the approximate rate on the best fully tax-exempt securities.

So, for the purpose of this table, we are using that 15 percent as the average, although there would be a variation.

Senator AUSTIN. Now, isn't it true that whatever is received by the investors has to be paid?

Mr. BLOUGH. That is correct.

Senator AUSTIN. So there is a 15 percent in the income on one end, and that represents cost on the other end.

Mr. BLOUGH. We must state that is the average, but not the specific item, as to that particular amount.

The CHAIRMAN. I do not want to inject another subject into this, but I do not agree with either one of you on that.

I am not sure that the Government took the position that all of these initial taxes would be shifted back to the municipalities and the States. Is that the view of the Treasury, that the entire amount of the tax would be shifted?

Mr. BLOUGH. By no means. The Government would gain a substantial net amount of tax; out of that gain there would be some loss due to interest increase, because many people would find the securities less attractive and would be less anxious to purchase them. But, we certainly would not agree that such loss of interest would in any way counteract the gains in the taxes.

Senator MILLER. What is the difference in tax rate on totally exempt bonds and on those only partially exempt that are outstanding?

Mr. BLOUGH. Senator, the partially tax-exempt bonds are exempt only from the normal tax; in the case of individuals, the normal tax rate is 4 percent. The partially exempt bonds are taxable under the surtax rates, which go from 4 percent to 75 percent.

The totally exempt bonds are exempt, not only from the normal tax, which is the smaller amount, but also the surtax; so the partially exempt bonds are not very attractive to persons are who trying to escape taxation in the higher brackets.

Senator MILLER. I know, but what is the difference in the rate of interest?

Mr. BLOUGH. Mr. Murphy, I am afraid, will have to come in here and explain that.

Mr. MURPHY. Our estimate of increase in interest cost on long term bonds——

Senator MILLER. I am not asking what will occur in the future, but what is occurring now.

Senator AUSTIN. He wants to know what the contract is now.

Senator MILLER. The Treasury ought to know that.

Mr. MURPHY. It is the differential. The obligations of State and municipalities——

Senator MILLER. I am talking about United States Government bonds.

Mr. MURPHY. The United States Government has outstanding practically no long-term wholly tax-exempt bonds. The amount is about $200,000,000.

Senator MILLER. The point is this: You have certain Federal totally exempt bonds drawing a certain amount of interest?

Mr. MURPHY. Yes, sir.

Senator MILLER. You have outstanding certain Federal bonds which are not totally tax-exempt. What is the difference between the interest rate on the totally exempt bonds and those that are not totally exempt?

Mr. MURPHY. I think I can explain it in this way: Here is the chart which shows the yield of the——

Senator MILLER. I do not want the yield. I want to know the contract.

Mr. MURPHY. Here is the difficulty. The tax-exempt feature is so relatively unimportant in determining the yield as compared with the maturity that bonds can only be compared if you have the same maturities.

It just so happens that at the time of issuance all of our securities of less than 5 years' maturity are wholly tax-exempt, and all of our securities which have maturities of more than 5 years are only partially exempt.

The wholly tax-exempt short-term securities will yield less than 1 percent, and the most recent coupons we put out were 1⅛ percent. The securities are now selling to yield less than 1 percent. At the same time we sold those securities, we also sold two issues of partially tax-exempt securities. A 9-year security carried a 2-percent coupon and a 27-year security a 2¾ coupon.

Now, a person might say that the partially tax-exempt securities yielded 2¾, while the wholly tax-exempts yielded 1⅛. Witnesses that have appeared in opposition have done something similar, but that is not the answer at all.

One security is a 5-year security, and the other is longer than 5 years, and if we had put out partially exempt securities with the same maturity as the wholly tax-exempts, they would probably have been put out at less than 1⅛. So that is not a proper comparison.

Senator MILLER. I am not interested in the yield, or what the investor would receive. I am interested in what the Government would pay.

Mr. MURPHY. After a given time, those two are the same. They converge as a security approaches maturity.

In the course of my testimony I will have an opportunity to go into this fully, and give the reasons.

Senator MILLER. You go into it. I just thought I would get a plain, ordinary, corn-field answer.

Mr. BLOUGH. You could give to the Senator your estimate of partially exempt securities.

Mr. MURPHY. Yes, sir. I am sorry not to be able to give you more of a cornfield answer, Senator.

Senator MILLER. I am sure you will cover that.

Mr. BLOUGH. You will see in this second bank on Exhibit A that we have the fully taxed securities substituted for the fully tax-exempts, and suppose on the average the interest yield was about 15 percent more, how would the position of the income receiver be after he paid his income tax, and we say that he would be very much worse off in the higher bracket and no worse off in the lower bracket, as a matter of fact, a little better off at the $5,000 level, and he is better off at the $10,000 level, and, in some spots, he is about the same in the $20,000 level.

Then, in the third bank, you have the percentage of income left after tax under the present law, as compared with the amount of income left after the tax under the proposal.

There, again, you can see that under the present law as the size of the income goes up, the gain under the present fully tax-exempt feature is increased.

I do not know whether that helps to clarify the matter or not, but in brief my opposition to Professor Lutz's breaking point of $60,000 is, that a man can gain by buying some tax-exempt securities without putting his whole fortune into tax-exempt securities. This point is around an $18,000 income, and you have about 96,000 people who are above that level.

So, we believe that 96,000 to 100,000, as reported on the income-tax returns, is a much better reflection of the number of people who are in a position to benefit from the tax-exempt securities than the 13,000 people. I do not know if I have gone into that too much.

Senator AUSTIN. I would like to ask, if you would take the same premise taken by Mr. Lutz, whether you would arrive at the same conclusion; that is, six-tenths?

Mr. BLOUGH. If we would take six-tenths——

Senator AUSTIN. No.

If you assume the same premise as Mr. Lutz, would you arrive at the same answer?

Mr. BLOUGH. You mean six-tenths?

Senator AUSTIN. Yes.

Mr. BLOUGH. If we assume the same premise, and look for the differential—let me say I have not figured it. There, again, I say we should make way for Mr. Murphy, who has worked out a summary. I would like to ask him if, in his computations, we would arrive at the six-tenths.

Mr. MURPHY. I should say no. I will amplify that——

Senator AUSTIN. It appears to me that if I wanted to persuade anyone who was judging this question that another fellow's figures were wrong, I would start where he started, and calculate it out on my own theory and make a comparison, instead of going ahead and attacking his figures by assuming something entirely different to begin with; that is, adopting a different premise. It does occur to me that it would be simpler for us to follow you, if you started off where he did.

Mr. BLOUGH. On this particular point in question, I did. I accepted his six-tenths of 1 percent. His breaking point then would be $35,000 instead of $60,000.

Senator AUSTIN. I know, but you are trying to induce us to believe that his conclusion is wrong, and his differential is much too high, are you not?

Mr. BLOUGH. The number of persons who would be able to gain by tax exemption was the point on which I was working at the moment.

Senator AUSTIN. Then you are not trying to make us believe his six-tenths of 1 percent is erroneous?

Mr. BLOUGH. No. I said, if you accept that, his conclusion is erroneous, and the breaking point would be 35,000 instead of 60,000.

Senator AUSTIN. All right.

Mr. BLOUGH. I am sorry if I have not made myself clear.

It is submitted that the existence of 100,000 taxpayers, who reported about $4,000,000,000 of net income or more than one-fourth of the total income reported on individual income-tax returns, and who are in position to gain by tax exemption—and have gained an undetermined amount—constitutes a serious threat to the progressiveness of income tax.

In addition to showing how much persons would be in a position to save by investing in tax-exempt securities, we have made an analysis of 25 individuals, each of whom, in 1937, reported net incomes in excess of $1,000,000.

Exhibit B. Individual Income Tax

Wholly tax-exempt interest, net income from other sources,[1] tax liability, effective rate of tax on net income plus tax-exempt interest, and net income plus tax-exempt interest after tax, as reported for 1937 by 25 persons with net incomes in excess of $1,000,000, together with comparable data under a proposal that the interest on Government obligations be made taxable [1]

[Dollar amounts in thousands]

Case No.	Data from tax returns for 1937					Comparable data under proposal to tax interest on Government obligations [1]				1937 net income after tax as a percent of net income after tax under the proposal
	Wholly tax-exempt interest	Net income from other sources [2]	Tax liability	Effective value of tax on net income plus tax-exempt interest	Net income plus tax-exempt interest after tax	Net income plus 115 percent of tax-exempt interest	Tax liability	Effective rate on proposed basis	Net income after tax	
				Percent				Percent		Percent
1	$85	$1,024	$608	62.9	$411	$1,122	$773	68.9	$349	117.8
2	6	1,595	1,138	71.1	463	1,602	1,144	71.4	458	101.0
3	180	1,482	1,050	63.2	612	1,689	1,210	71.6	479	127.6
4	121	2,048	1,486	68.5	683	2,187	1,595	72.9	592	115.4
5	322	1,209	840	54.9	691	1,579	1,125	71.2	454	152.2
6	......	1,399	986	70.5	413	1,399	986	70.5	413	100.0
7	......	1,851	1,334	72.1	517	1,851	1,334	72.1	517	100.0
8	3	1,256	876	69.6	383	1,259	878	69.7	381	100.5
9	17	1,388	977	69.5	428	1,408	992	70.5	416	103.0
10	48	1,040	711	65.3	377	1,095	753	68.8	342	110.4
11	322	4,446	3,357	70.4	1,411	4,816	3,646	75.7	1,170	120.5
12	54	2,533	1,865	72.1	722	2,595	1,913	73.7	682	105.9
13	17	2,283	1,671	72.7	629	2,303	1,686	73.2	617	102.0
14	110	1,540	1,095	66.4	555	1,667	1,193	71.6	474	117.0
15	79	1,931	1,397	69.5	613	2,022	1,467	72.6	555	110.5
16	......	2,153	1,570	72.9	583	2,153	1,570	72.0	583	100.0
17	......	1,072	735	68.6	337	1,072	737	68.6	337	100.0
18	547	2,150	1,507	58.1	1,130	2,779	2,058	74.1	721	156.7
19	89	2,042	1,482	69.5	649	2,144	1,561	72.8	583	111.4
20	399	1,588	1,132	57.0	855	2,047	1,486	72.6	561	152.3
21	67	2,201	1,604	70.7	664	2,278	1,664	73.0	614	108.2
22	2,717	6,985	5,358	55.2	4,344	10,110	7,827	77.4	2,283	190.3
23	1,629	1,414	999	32.8	2,044	3,287	2,454	74.7	833	245.4
24	......	1,067	732	68.6	335	1,067	732	68.6	335	100.0
25	1	3,162	2,355	74.5	808	3,163	2,355	74.5	808	100.0
Total	6,813	50,859	37,015	64.2	20,657	58,694	43,137	73.5	15,557	132.8

[1] Assuming that the interest rate on Government obligations would increase 15 percent if such interest were made taxable.
[2] Inclusive of partially tax-exempt interest.

Source: Treasury Department, Division of tax research.

This exhibit that we have here shows cases Nos. 1 to 25. These are actual cases, taken from the income-tax returns for 1937.

These 25 individuals reported almost $7,000,000 of wholly tax-exempt interest. Even ignoring the likelihood that they under-reported their tax-exempt interest receipts, it was found that these 25 taxpayers had approximately one-third more net income after paying their income taxes than they would have had if the tax-exempt securities had been subject to taxation and yielded 15 percent more in interest. In one case an individual had 145 percent more net income than he would have had, and other percentages ranged from 90 percent down to no increases in the case of five individuals.

Senator Townsend. Have you anything showing how many incomes there were in excess of $1,000,000?

Mr. BLOUGH. Yes, sir; the figures are right here, a very small number, 61 for 1936 and 49 (preliminary) for 1937.

Senator TOWNSEND. And they have taken approximately half of them, half of that number, with incomes over a million dollars?

Mr. BLOUGH. Yes, sir.

In other words, these 25 people, on the average, were very substantially ahead in total net income than they would have been had Government securities not been tax-exempt. This table, which I would like to have inserted in the record at this point, shows clearly that large taxpayers do hold large blocks of fully tax-exempt securities, that they are deriving large benefits from the purchase of such securities, and that the progressive income tax rates are correspondingly nullified.

It thus appears that on all grounds considered, the nullifying effects of tax-exempt securities on progressive income taxation are very substantial, and not, as opponents have indicated, a minor and inconsequential matter.

A second argument that has been made against eliminating tax exemption is that the opportunity of persons in the higher-income brackets to gain through tax-exempt interest results in general public benefit because, as a result of their purchases of Government securities, interest rates are driven so much lower than they would otherwise be, that the loss in tax revenue to Government as a whole is more than offset by the interest saved.

Professor Lutz further argued that the mass of taxpayers accordingly have their taxes reduced. Thus, everyone gains: Persons with large incomes, persons with small incomes, and Government. The efforts of persons in the higher-income brackets to avoid income taxation thus take on a degree of nobility which has not heretofore been suspected.

To make this point more impressive, Professor Lutz emphasized that taxpayers should not be divided into local taxpayers, State taxpayers, and Federal taxpayers, but should be considered taxpayers in general. It will be remembered that Mr. Hanes makes the same point.

From sheer logic alone, Professor Lutz's argument that everyone gains appears to be bootstrap economics at its best.

It would be anomalous indeed if so small a number of benefited persons could cause as large a differential in interest rates as he concludes. There is much more logic to the belief that even a large number of benefited persons can produce only a small interest differential if the volume of tax-exempt securities available for their purchase is greatly in excess of their demand.

The error of Professor Lutz's argument becomes clearer as the facts are examined. Mr. Hanes, in his statement of January 18, pointed out that if tax exemption were removed and all presently exempt securities were replaced by others, the eventual resultant annual increase in Federal income-tax revenue would range from $179,000,000 to $337,000,000, while the annual eventual increase in interest cost to the Federal Government and Federal instrumentalities would range from $19,000,000 to $50,000,000, and to State and local governments from $40,000,000 to $105,000,000. Thus, taking the highest cost estimates and the lowest revenue estimates, of the Treasury, and considering no gain to States whatever, the additional revenue would exceed the additional interest costs.

The Treasury figures are based on careful studies made of probable interest differentials and revenues to be derived from income taxes. Analyses of the differences between the techniques and assumptions used by Professor Lutz and those used in the Treasury studies have been prepared and, with your permission, will be presented at the conclusion of my statement.

If the Treasury estimates are valid, and the methodology is believed to be sound, the benefit to the mass of taxpayers that Professor Lutz anticipates disappears and is replaced by a loss to them.

There are other reasons, also, for taking the position that the small income groups lose rather than gain by tax exemption. The net addition in taxes that must be raised fall, in large part, on the smaller income groups, since it has proved necessary to use excise taxes and other consumption taxes to supplement the progressive levies imposed by the Federal and State Governments.

Furthermore, the reduction in interest rates, however small, which securities command because of tax exemption falls very largely on the smaller income groups.

The lower interest yield makes it necessary for insurance companies to charge higher premiums. It decreases the return that the small investor secures on his savings in banks. It reduces the earnings of charitable and educational endowments. Public sinking, trust, and investment funds of governments and their agencies, now totaling collectively more than $11,000,000,000 of public securities, receive less interest.

Some people, to whom public securities are otherwise a highly desirable form of investment, do not buy them because of the low yields. Others lose some yields on their investments, due to tax exemption which is of no value to them. The mass of the people thus lose through tax exemption.

It has been urged by the opposition that eliminating tax exemption on future issues of securities would injure the financial position of banks and insurance companies. Mr. Chatters developed this argument.

This might be correct if it were desired to tax outstanding issues. Limitation of the repeal of exemption to future issues, however, gives exactly the opposite result.

The outstanding tax-exempt securities will increase in value as they become scarcer, since they will be demanded for investment by persons with large incomes.

As a result, banks, insurance companies, sinking funds, public trust and investment funds, governments and their agencies, endowments and other holders of tax-exempt securities will be in a position to gain through the increase in the value of their securities. Accordingly, the public at large will make some gain, even during the period while tax-exempt securities are still outstanding by selling their holdings of such securities to persons in the higher income brackets at increasing prices.

The point has been presented to this committee, again and again, that State and local governments, especially the cities, would lose heavily if future issues were denied tax exemption. It should be observed that, to the extent that this argument is correct, States and localities are now receiving subsidies at the expense of the general taxpayers. If interest differentials are due to tax exemption, they have been created almost entirely by the Federal income tax and are thus, in effect, a subsidy of the Federal Government to States and local units of government, which is paid by the general taxpayers of the country.

Subsidies are not in themselves necessarily objectionable. The Federal Government has, for more than a quarter of a century, been giving subsidies and grants of various kinds to States and localities. States, in turn, have been giving subsidies to their subdivisions.

In general, a subsidy by tax exemption is less desirable than a cash subsidy, because it is hidden and may not go to the persons or jurisdictions intended.

However, if we overlook the subsidy now being given and concentrate only on future increases in costs which might be reasonably anticipated to result from ending tax exemption, the factual picture is much different from that presented by opponents of eliminating exemption.

First, the increase in interest costs to State and local governments would be realized only gradually as existing securities were retired and new ones were issued to finance new projects. If it be assumed, for the sake of simplicity, that the new issues exactly equal those retired, half the outstanding securities will not be retired until after 1950, and the full effect will not be felt completely for nearly 50 years.

We have used one-quarter of 1 percent interest increase. We used that because it is very easy to compute. If you think that a three-eighths differential would be better, you simply add one-half of one-quarter, and if you think it should be one-half, you can double it, and, if three-quarters, treble it.

The CHAIRMAN. This general line suggests a question to my mind, which I think that the Treasury should give consideration to before we conclude the hearings.

What effect does the exemption of refunding bonds have upon this situation that you are now discussing?

That is the first proposition, and, second, can the Treasury figure any way in which we could safeguard the proposition of exempting refunding bonds so that the money received from them would not be used for other purposes?

We discussed that question with other people, and we got answers both ways. One gentleman, from Birmingham, said it could be done very easily, without much danger of fraud being perpetrated. On the other hand, I think one of the experts said he did not see how it possibly could be done without danger to the integrity of the Treasury funds.

I would like to have that question discussed by someone in the Treasury.

If we should do this thing, I think we should give serious consideration to that matter of refunding bonds issued on a real, necessary basis.

Mr. BLOUGH. This is a refunding to extend the life of the bond, if the jurisdiction is not able to pay off at maturity?

The CHAIRMAN. Yes. That is a subject very close to what we are discussing right now.

Mr. BLOUGH. Here we are assuming that the refunding of another issue would be taxable, and this is putting it at its worst. If there was some way of protecting refunding issues against taxation, the municipalities and the States would not have any increase, but, even if you did not, the figures I am about to submit show the increase in costs to the municipalities and the States are not necessarily as serious as has been presented to the committee, but, when we are through that whole point, if it has not been discussed to your satisfaction, we will be glad to discuss the specific points.

The CHAIRMAN. I had two propositions: Should it be done; and, second, if it can be done, can it be done safely?

Mr. BLOUGH. May we postpone that until later?

The CHAIRMAN. Yes.

(Mr. Hanes submitted a memorandum on the probable effects of discontinuing the issuance of tax-exempt securities on the refunding operations of State and local governments, with some consideration of possible relief provisions. This memorandum will be found following Mr. Blough's testimony.)

Mr. BLOUGH. On the basis of the 1937 State and local bonded debt and assuming that the taxation of future issues of securities will result in a quarter of 1 percent increase in interest rates, interest costs would be increased, by 1945, for example, by only 2 percent of the 1937 interest costs, or only 12 cents per capita. To this should be added an amount for short-term debt, which, however, is slight, for the interest differential on such debt must be very minor. Even at the end of 50 years, when all exempt securities have been retired, interest costs would be increased by only 35 cents per capita—1938 population—or about one-half of 1 percent of the total State and local budget in 1937.

Your attention is called to the fact that these computations are based on an interest differential of one-fourth of 1 percent. The costs would be proportionately higher if the differential is greater, but even assuming Professor Lutz's differential of six-tenths of 1 percent, the total eventual cost would be only about 84 cents per capita, or slightly over 1 percent of the total 1937 State and local Budget. These figures are given, not to attempt to prove that there will be no cost, but that such cost is not relatively a heavy one, and that it will not really be felt for 12 to 15 years, and not completely for 50 years.

Detailed figures for each year are shown in exhibit C, which I should like to have go into the record at this point, together with exhibit D, showing the maturity schedule of the bonded debt of selected State governments.

EXHIBIT C

Estimated increase in annual interest costs on the bonded debt of State and local governments on the basis of the estimated maturity of the June 30, 1937 debt, assuming that the taxation of future issues of State and local securities will result in a ¼ of 1 percent increase in interest rates [1]

[Amount of maturities and interest costs in millions, percentages in units of 1 percent, per capitas in units of 1 dollar]

Year	Cumulative maturities		Increased interest costs		
	Amount	Percent of total	Amount	Percent of 1937 interest costs	Per capita
1938	$755.0	4.13	$1.9	0.25	$0.01
1939	1,534.8	8.40	3.8	.49	.03
1940	2,327.9	12.74	5.8	.75	.04
1941	3,277.0	17.94	8.2	1.07	.06
1942	4,002.4	21.91	10.0	1.30	.08
1943	4,740.0	25.95	11.9	1.55	.09
1944	5,488.6	30.05	13.7	1.78	.11
1945	6,178.9	33.83	15.4	2.00	.12
1946	6,739.5	36.90	16.8	2.18	.13
1947	7,307.3	40.01	18.3	2.38	.14
1948	7,793.4	42.67	19.5	2.53	.15
1949	8,331.4	45.62	20.8	2.70	.16
1950	8,869.6	48.57	22.2	2.89	.17
1951	9,435.4	51.67	23.6	3.07	.18
1952	9,949.5	54.48	24.9	3.24	.19
1953	10,419.4	57.05	26.0	3.39	.20
1954	11,051.3	60.51	27.6	3.59	.21
1955	11,670.6	63.90	29.2	3.80	.22
1956	12,187.6	66.73	30.5	3.96	.23
1957	12,657.1	69.30	31.6	4.11	.24
1958	13,037.3	71.38	32.6	4.24	.25
1959	13,405.3	73.39	33.5	4.35	.26
1960	13,906.6	76.13	34.8	4.52	.27
1961	14,183.3	77.64	35.5	4.61	.27
1962	14,554.4	79.67	36.4	4.73	.28
1963	15,000.9	82.11	37.5	4.87	.29
1964	15,460.0	84.62	38.7	5.03	.30
1965	15,788.5	86.42	39.5	5.13	.30
1966	16,061.9	87.92	40.2	5.23	.31
1967	16,324.7	89.36	40.8	5.30	.31
1968	16,406.5	89.81	41.0	5.33	.31
1969	16,529.8	90.49	41.3	5.37	.32
1970	16,629.9	91.04	41.6	5.41	.32
1971	16,764.9	91.78	41.9	5.45	.32
1972	16,840.1	92.19	42.1	5.47	.32
1973	16,880.6	92.41	42.2	5.49	.32
1974	16,963.5	92.87	42.4	5.51	.33
1975	17,165.7	93.98	42.9	5.58	.33
1976	17,355.4	95.02	43.4	5.64	.33
1977	17,683.6	96.82	44.2	5.75	.34
1978	17,772.4	97.31	44.4	5.78	.34
1979	17,947.4	98.27	44.9	5.84	.34
1980	18,098.2	99.10	45.2	5.88	.35
1981	18,201.0	99.66	45.5	5.91	.35
1982	18,227.3	99.80	45.6	5.93	.35
1983	18,245.0	99.90	45.6	5.93	.35
1984	18,250.3	99.93	45.6	5.93	.35
1985	18,254.0	99.95	45.6	5.93	.35
1986	18,201.3	99.99	45.7	5.94	.35
1987	18,262.4	100.00	45.7	5.94	.35

[1] It is assumed that all securities will remain outstanding until their final maturity dates.

Source: Treasury Department, division of tax research.

EXHIBIT D

Amount and percent of the present bonded debt of selected State governments that will be retired by Jan. 1 of selected future years, assuming that all securities will remain outstanding until their final maturity dates

[Amounts in thousands of dollars]

States	1940	1945	1950	1960	1970	1980	1990	Year of final maturity
1. Amount of present bonded debt:								
New Jersey	31,885	170,265	181,545	304,065	337,433	337,605	....	1970
Mississippi	4,140	14,098	24,848	36,601	....	....	....	1953
Massachusetts	50,543	99,993	121,219	139,818	147,154	149,344	149,573	1981
Illinois	23,345	82,280	124,580	197,280	....	....	....	1959
Oregon	13,078	49,861	73,343	90,818	90,968	....	....	1960
New York	53,733	217,078	312,838	430,549	648,900	672,575	681,523	1987
2. Percent of present bonded debt:								
New Jersey	9.44	50.43	53.77	90.07	99.95	100.00	....	1970
Mississippi	11.31	38.52	67.89	100.00	....	....	....	1953
Massachusetts	33.79	66.85	81.04	93.48	98.38	99.85	100.00	1981
Illinois	11.83	41.71	63.15	100.00	....	....	....	1959
Oregon	15.04	54.81	80.63	99.84	100.00	....	....	1960
New York	7.88	31.84	45.88	63.15	95.17	98.64	100.00	1987

Source: Treasury Department, division of tax research.

Now, exhibit C, you will observe, shows the estimated increase in annual interest costs on the bonded debt of State and local governments on the basis of the estimated maturities as of June 30, 1937, assuming that the taxation of future issues of State and local securities will result in one-fourth of 1 percent increase in the interest rate.

We have calculated there the maturities, according to maturity schedules of State and local debts, and show how much interest costs will increase during each of the years up to 1987.

The second column shows the percent that has matured up to that point, and you will see by 1950, 48.57 percent had matured. By 1951, 51.67 percent had matured, and it is not until 1969 that there is 90 percent—to be exact, 90.49—that had matured.

Then the increased interest cost. On the basis of one-fourth of 1 percent, by 1987, it is estimated that the increased interest costs would be $45,700,000, while in 1945 it would be only $15,400,000.

The next column shows the percent of that increase to the 1937 interest costs, and finally, the per-capita figure.

This, I think, may be useful to you in calculating the date at which this cost becomes effective.

Exhibit D takes a few States that we happen to have on hand at the moment, and shows from that how much of the State debt in those States matures in various years, and what is the year of final maturity in each case, and there is shown the rate of the percent of present bonded indebtedness, and the date of maturity.

This may be helpful to the committee.

Professor Lutz and others appearing before your committee have placed considerable stress upon the increased local property tax rates which will follow the discontinuance of the issue of tax-exempt securities.

For purposes of illustration, Professor Lutz submitted estimates for the 13 cities having a population of over 500,000. His computations indicated that under conditions prevailing in 1936 the taxation of local issues would have resulted in an increased tax rate ranging from 42 cents per thousand dollars of assessed valuation in Milwaukee to $2.10 in Detroit.

It is our contention that these figures greatly overstate the probable results. This overstatement is caused in part by the assumption of an excessively high interest differential but primarily by the assumption that all debt constitutes a burden on general property. Professor Lutz's computations overlooked the fact that a substantial portion of the debt of these cities is paid directly from public utility receipts and special assessments, and, moreover, that only a portion of that payable from general revenues falls on real estate. Varying proportions of general revenues in different cities are, of course, derived from non-property-tax sources. Moreover, Professor Lutz's estimates present the increased cost which will appear only after all the present indebtedness has been retired. This, as I have already noted, will not occur for 50 years.

Estimated increase in the property tax rates of 13 cities having a population above 500,000 resulting from the taxation of future issues of municipal securities

ESTIMATED INCREASE IN TAX RATE, PER $1,000 OF ASSESSED VALUATION [1]

City	1936 tax rate (actual)	Lutz estimate [2]	U. S. Treasury estimate [3]		
			1940	1950	Year of final maturity
New York	$27.14	$0.87	$0.01	$0.03	$0.15
Chicago	95.20	1.73	.03	.08	.35
Philadelphia	20.24	1.03	.01	.08	.23
Detroit	27.90	2.10	[4]	.05	.20
Los Angeles	32.06	.95	.01	.07	.15
Cleveland	28.61	.78	.03	.13	.16
St. Louis	26.89	.46	.02	.09	.13
Baltimore	21.69	.50	.01	.05	.11
Boston	37.74	.65	.03	.11	.14
Pittsburgh	37.14	.85	.02	.14	.28
San Francisco	26.76	.92	.01	.08	.13
Milwaukee	32.27	.42	.03	.11	.12
Buffalo	33.06	.01	.03	.15	.19

[1] Applies to last 4 columns only.
[2] Harley L. Lutz, The Fiscal and Economic Aspects of the Taxation of Public Securities, p. 87.
[3] Assumes an increase in the interest rate of ¼ of 1 percent. For other specifications see exhibit E.
[4] Less than 1 cent.

Source: Treasury Department, Division of Tax Research.

The CHAIRMAN. You have a little table inserted at this point. What does that represent?

Mr. BLOUGH. So that you will understand what we are getting at. We are getting our basis.

In the first place, you will see that we are using the one-quarter percent, and any higher figure can be used by multiplying the one-quarter percent.

In the second place, we are trying to find out how much is raised on property, and not by utilities. For instance, take the city of Detroit figure that has been submitted to the committee. As a matter of fact, a great percent of the debt in Detroit today is from the street railways and water works, which are not served from taxes, at all, and this table indicates just such increase in taxes, and it shows about a 16-cent increase in the tax rate in the year of final maturity?

The CHAIRMAN. That is cents, and not percentages?

Mr. BLOUGH. Yes, sir.

The CHAIRMAN. In other words, taking Detroit, you have 27.90, and, according to Professor Lutz, that would be 30, and, according to the Treasury, it would mean that in 1950 it would be 27.95.

Mr. BLOUGH. That is right.

The CHAIRMAN. And you arrive at the figure at the year of final maturity of 28.10?

Mr. BLOUGH. That is right.

The largest part of the difference between Professor Lutz's statement and ours is that he assumes that all of the debt of Detroit is a burden on real property, and any increase in interest would be a general burden on property, whereas a large part of Detroit's debt today is public service enterprise debt.

To illustrate the degree of overstatement of Professor Lutz's point, we have made detailed computations of the probable effects of increased interest costs on local property tax rates. These computations indicate that, if tax exemption had been discontinued last year, the increased cost of borrowing would have resulted, by 1950, in an additional tax rate ranging from 3 cents per thousand dollars of assessed valuation in New York City to 15 cents in Buffalo. Even in the year of final maturity, the increased tax rate would in no case amount to more than 35 cents per thousand dollars of assessed valuation.

With respect to the data here presented, it should be emphasized that full allowance has been made not only for the city debt but for the city's share of all overlapping local debt and that the computations are based on the assumption that the taxation of future issues of municipal securities would result in a fourth of 1 percent increase in interest rates.

The CHAIRMAN. Are you assuming in this discussion that the entire addition in the interest rate is being paid by the city?

Mr. BLOUGH. We are assuming the entire addition is being paid from the same source that the interest rate is now being paid from, and we are thinking about the tax on the area, and not simply on the city separately.

We are assuming that all of the local governments are consolidated into one body, so that there is no debt on the side, or something like that. It is all in here, and we are assuming that the future increase in interest would be paid from the same source that the present interest is paid from, for we are trying to get at the amount of those apportionments that would fall on the real property.

Should the resulting increase in interest rates be as high as one-half of 1 percent, the effects on the property tax rate would, of course, be double those indicated. In any case, they are only a fraction of those suggested by Professor Lutz. The basis of these computations, together with the results, are presented in full detail in exhibit E, which I should like to have inserted in the record.

Exhibit E

Table 1.—*Present bonded debt of cities having a population of over 500,000 and their overlapping units, showing overlapping debt allocated to cities and distribution of total debt by (1) debt payable from utilities and special assessments, (2) debt payable from general revenues, and (3) debt payable from property taxes*

[Amounts in thousands of dollars]

City and overlapping units	Bonded debt		City's share of bonded debt[1]	City's share of bonded debt payable from—		
	Date	Amount		Utility revenues and special assessments	General revenues: Total[2]	General revenues: Payable from property taxes[3]
New York	Jan. 1, 1938	$2,380,404	$2,380,404	$725,932	$1,654,472	....
Triborough Bridge	do	53,000	53,000	53,000	....	....
New York Tunnel Authority	do	19,000	19,000	19,000	....	....
New York Planetarium	do	620	620	620	....	....
New York Parkway Authority	do	18,000	18,000	18,000	....	....
Total	....	2,471,024	2,471,024	816,552	1,654,472	$1,026,269
Chicago	Jan. 1, 1938	182,746	182,746	42,648	140,098	....
Board of education	Mar. 3, 1938	37,202	37,202	....	37,202	....
Park district	do	102,505	102,505	....	102,505	....
Cook County	do	37,923	31,203	....	31,203	....
Forest Preserve District	do	12,840	10,565	....	10,565	....
Sanitary district	do	124,989	104,241	....	104,241	....
Total	....	498,205	468,462	42,648	425,814	292,832
Philadelphia	Jan. 1, 1938	548,071	548,071	175,383	372,688	....
School district	do	70,595	70,595	....	70,595	....
Total	....	618,666	618,666	175,383	443,283	318,896
Detroit	Jan. 1, 1939	376,319	376,319	104,832	271,487	....
Wayne County	do	5,464	4,096	3,291	805	....
Total	....	381,783	380,415	108,123	272,292	193,572
Los Angeles	Jan. 1, 1938	230,858	230,858	185,278	45,580	....
Los Angeles County	do	4,700	2,562	....	2,562	....
Metropolitan Water District	June 30, 1938	149,978	109,274	109,274	....	....
Flood Control District	Jan. 1, 1938	30,362	19,785	....	19,785	....
Los Angeles elementary schools	do	37,572	32,067	....	32,067	....
Los Angeles high schools	do	31,564	26,472	....	26,472	....
Junior College	do	342	276	....	276	....
Total	....	485,376	421,293	294,552	126,742	79,885
Cleveland	Sept. 1, 1937	106,200	106,200	26,082	80,118	....
Cuyahoga County	do	[4] 35,794	25,056	....	25,056	....
City-school district	June 30, 1937	11,181	11,181	....	11,181	....
Total	....	153,175	142,437	26,082	116,355	77,341
St. Louis	Jan. 1, 1938	82,231	82,231	13,273	68,958	....
City-school district	Nov. 1, 1937	3,516	3,516	....	3,516	....
Total	....	85,747	85,747	13,278	72,474	54,080
Baltimore	Jan. 1, 1938	185,625	185,625	50,249	135,376	87,169
Boston	do	152,076	152,077	63,698	88,379	....
Suffolk County	do	1,642	1,642	....	1,642	....
Metropolitan Transit District & Elevated R. R. Co.	do	55,564	36,784	22,059	14,725	....
Cambridge Subway	Nov. 30, 1938	7,234	4,789	4,789	....	....
Metropolitan water district	do	73,887	46,779	42,125	4,654	....
Other metropolitan districts	do	18,907	7,090	....	7,090	....
Total	....	309,310	249,161	132,671	116,490	89,429

[1] Allocation of bonded debt to city on the basis of assessed valuation excepting where specified otherwise by statute.

[2] Includes utility bonds currently payable from general revenue. The special assessments of Cleveland are payable from general revenue and those of Detroit have been refunded into general obligations.

[3] Proportion of general revenue debt based on the ratio of property tax revenue to total general revenue in 1936 of the city and overlapping units, as reported by the Bureau of the Census, Financial Statistics of Cities, 1936.

[4] Exclusive of relief bonds payable from State revenue and special assessments on property outside of city.

Source: Treasury Department, division of tax research.

TABLE 1.—*Present bonded debt of cities having a population of over 500,000 and their overlapping units, showing overlapping debt allocated to cities and distribution of total debt by (1) debt payable from utilities and special assessments, (2) debt payable from general revenues, and (3) debt payable from property taxes*—Continued

[Amounts in thousands of dollars]

City and overlapping units	Bonded debt		City's share of bonded debt	City's share of bonded debt payable from—		
				Utility revenues and special assessments	General revenues	
	Date	Amount			Total	Payable from property taxes
Pittsburgh	Jan. 1, 1938	\$61,127	\$61,127	\$5,745	\$55,382	....
Allegheny County	Apr. 1, 1937	108,943	70,813	....	70,813	....
City-school district	June 30, 1937	21,263	21,263	....	21,263	....
Total	....	191,333	153,203	5,745	147,458	\$123,997
San Francisco	June 30, 1938	161,144	161,144	84,348	76,796	....
Golden Gate Bridge	Jan. 1, 1938	35,000	29,610	29,610	....	....
Total	....	196,144	190,754	113,958	76,796	53,258
Milwaukee	June 3, 1937	31,555	31,555	3,065	28,490	....
Milwaukee County	Aug. 31, 1937	12,941	10,094	....	10,094	....
Metropolitan Sewerage district	Dec. 15, 1937	20,060	16,064	....	16,064	....
Total	....	64,576	57,713	3,065	54,648	·0,073
Buffalo	June 30, 1938	118,711	118,711	18,073	100,638	....
Erie County	Jan. 1, 1938	32,980	24,734	....	24,734	....
Sewer Authority	Nov. 2, 1938	8,250	8,250	....	8,250	....
Total	....	159,941	151,695	18,073	133,622	75,296

TABLE 2.—*Estimated amount of present bonded debt (including overlapping debt) of cities having a population of over 500,000 that will be retired by selected future dates, showing cumulative maturities of (1) total bonded debt, (2) bonded debt payable from general revenues, and (3) bonded debt payable from property taxes* [1]

[In thousands of dollars]

City area	Amount of present debt estimated to be retired by Jan. 1—					
	1940	1945	1950	1960	1970	Year of final maturity
1. Total bonded debt:						
New York	114,298	362,340	485,469	1,097,658	1,662,538	2,471,024 (2147)
Chicago	40,754	98,626	135,030	468,462	468,462	468,462 (1957)
Philadelphia	31,874	117,433	193,388	271,336	291,070	618,666 (1987)
Detroit	3,673	40,704	113,356	243,269	380,415	380,415 (1966)
Los Angeles	24,425	87,595	153,885	274,327	350,721	421,293 (1988)
Cleveland	22,768	75,590	114,112	134,572	140,430	142,437 (1974)
St. Louis	10,383	41,457	63,538	85,747	85,747	85,747 (1956)
Baltimore	12,529	48,750	76,914	135,734	173,341	185,625 (1981)
Boston	30,356	96,644	140,060	185,634	212,727	249,161 (1984)
Pittsburgh	13,340	53,415	80,017	126,534	153,203	153,203 (1967)
San Francisco	11,543	50,254	87,793	144,225	182,682	190,754 (1977)
Milwaukee	14,728	40,473	54,311	57,713	57,713	57,713 (1956)
Buffalo	21,054	74,239	111,099	144,558	151,692	151,695 (1970)
2. Bonded debt payable from general revenues:						
New York	81,244	278,250	358,020	834,834	1,207,700	1,654,472 (2147)
Chicago	33,279	72,049	95,782	425,814	425,814	425,814 (1957)
Philadelphia	24,437	88,812	145,748	207,139	220,518	442,233 (1987)
Detroit	1,198	17,855	69,705	163,645	272,292	272,292 (1963)
Los Angeles	10,833	37,785	63,730	108,787	126,391	126,741 (1971)
Cleveland	19,884	65,703	94,405	111,038	114,818	116,355 (1971)
St. Louis	8,680	31,584	50,615	72,474	72,474	72,474 (1956)

[1] It is assumed that all securities will remain outstanding until their final maturity dates. For other specifications, see table 1.

TABLE 2.—*Estimated amount of present bonded debt (including overlapping debt) of cities having a population of over 500,000 that will be retired by selected future dates, showing cumulative maturities of (1) total bonded debt, (2) bonded debt payable from general revenues, and (3) bonded debt payable from property taxes*—Con.

[In thousands of dollars]

City area	Amount of present debt estimated to be retired by Jan. 1—					
	1940	1945	1950	1960	1970	Year of final maturity
2. Bonded debt payable from general revenues—Con.						
Baltimore	9,476	37,985	56,994	95,761	123,806	135,376 (1981)
Boston	23,258	67,427	91,654	106,792	110,889	116,490 (1984)
Pittsburgh	12,321	50,493	75,641	120,758	147,458	147,458 (1967)
San Francisco	6,569	27,329	44,943	65,471	74,756	76,796 (1977)
Milwaukee	14,390	39,279	52,261	54,648	54,648	54,648 (1952)
Buffalo	19,746	69,811	105,049	129,808	133,619	133,622 (1970)
3. Bonded debt payable from property taxes:						
New York	50,396	172,598	222,080	517,848	749,136	1,026,269 (2147)
Chicago	22,886	49,961	65,869	292,832	292,832	292,832 (1957)
Philadelphia	17,580	63,891	104,851	149,016	158,641	318,898 (1987)
Detroit	852	12,693	49,553	116,335	193,572	193,572 (1963)
Los Angeles	6,828	23,816	40,169	68,568	79,664	79,885 (1971)
Cleveland	13,217	43,673	62,751	73,807	76,320	77,341 (1971)
St. Louis	6,477	23,568	37,769	54,080	54,080	54,080 (1956)
Baltimore	6,102	24,459	36,698	61,661	79,719	87,169 (1981)
Boston	17,855	51,764	70,363	81,984	85,129	89,479 (1984)
Pittsburgh	10,361	42,460	63,607	101,571	123,097	123,997 (1967)
San Francisco	4,556	18,953	31,168	45,404	51,843	53,258 (1977)
Milwaukee	10,552	28,803	38,323	40,073	40,073	40,073 (1952)
Buffalo	11,127	39,338	59,195	73,147	75,294	75,296 (1970)

Source: Treasury Department, Division of Tax Research.

TABLE 3.—*Estimated percent of present bonded debt (including overlapping debt) of cities having a population of over 500,000 that will be retired by selected future dates, showing cumulative maturities of (1) total bonded debt, (2) bonded debt payable from general revenues, and (3) bonded debt payable from property taxes* [1]

City area	Percent of present debt estimated to be retired by January 1—					
	1940	1945	1950	1960	1970	Year of final maturity
1. Total bonded debt:						
New York	4.63	14.66	19.65	44.42	67.28	100.00
Chicago	8.70	21.05	28.82	100.00	100.00	100.00
Philadelphia	5.15	18.98	31.26	44.34	47.05	100.00
Detroit	.97	10.70	29.80	63.95	100.00	100.00
Los Angeles	5.80	20.79	36.53	65.12	83.25	100.00
Cleveland	15.98	53.07	80.11	94.48	98.59	100.00
St. Louis	12.11	48.35	74.10	100.00	100.00	100.00
Baltimore	6.75	26.26	41.44	73.12	93.38	100.00
Boston	12.18	38.79	56.21	74.50	85.38	100.00
Pittsburgh	8.71	34.87	52.23	82.59	100.00	100.00
San Francisco	6.05	26.34	46.02	75.61	95.77	100.00
Milwaukee	25.52	70.13	94.11	100.00	100.00	100.00
Buffalo	13.88	48.94	73.24	95.30	100.00	100.00
2. Bonded debt payable from general revenues, including debt payable from property taxes:						
New York	4.91	16.82	21.64	50.46	73.00	100.00
Chicago	7.82	17.06	22.49	100.00	100.00	100.00
Philadelphia	5.51	20.03	32.88	46.73	49.75	100.00
Detroit	.44	6.56	25.60	60.10	100.00	100.00
Los Angeles	8.55	29.81	50.28	85.83	99.72	100.00
Cleveland	17.09	56.47	81.14	95.43	98.68	100.00
St. Louis	11.98	43.58	69.84	100.00	100.00	100.00
Baltimore	7.00	28.06	42.10	70.74	91.45	100.00
Boston	19.97	57.88	78.68	91.67	95.19	100.00
Pittsburgh	8.36	34.24	51.30	81.91	100.00	100.00
San Francisco	8.55	35.59	58.52	85.25	97.34	100.00
Milwaukee	26.33	71.88	95.63	100.00	100.00	100.00
Buffalo	14.78	52.25	78.62	97.15	100.00	100.00

[1] It is assumed that all securities will remain outstanding until their final maturity dates. For other specifications, see table 1.

Source: Treasury Department, Division of Tax Research.

TABLE 4.—*Estimated increase in annual interest costs on the present bonded debt (including overlapping debt) of cities having a population of over 500,000, at selected future dates, assuming that the taxation of future issues of municipal securities will result in a one-fourth of 1 percent increase in interest rates* [1]

[In thousands of dollars]

City area	Interest cost, 1936	Estimated increase in annual interest cost by—					
		1940	1945	1950	1960	1970	Year of final maturity
1. Total bonded debt:							
New York	94,286	286	906	1,214	2,744	4,156	6,178
Chicago	20,261	102	247	338	1,171	1,171	1,171
Philadelphia	26,239	80	204	483	686	728	1,547
Detroit	29,855	9	102	283	608	951	951
Los Angeles	12,442	61	219	385	686	877	1,053
Cleveland	7,568	57	189	285	336	351	356
St. Louis	3,500	26	104	159	214	214	214
Baltimore	7,700	31	122	192	339	433	464
Boston	8,050	76	242	350	464	532	623
Pittsburgh	6,425	33	134	200	316	383	383
San Francisco	7,726	20	126	219	361	457	477
Milwaukee	3,057	37	101	136	144	144	144
Buffalo	5,692	53	186	278	361	379	879
2. Bonded debt payable from general revenues:							
New York	36,532	203	696	895	2,087	3,019	4,136
Chicago	18,994	83	182	230	1,065	1,065	1,065
Philadelphia	16,606	61	222	364	518	551	1,108
Detroit	23,952	3	45	174	409	681	681
Los Angeles	5,896	27	94	159	272	316	317
Cleveland	4,859	50	164	236	278	287	291
St. Louis	2,803	22	79	127	181	181	181
Baltimore	5,253	24	95	142	239	310	338
Boston	3,203	58	169	229	267	277	291
Pittsburgh	6,021	31	126	189	302	369	369
San Francisco	2,481	16	68	112	164	187	192
Milwaukee	2,883	36	98	131	137	137	137
Buffalo	4,906	49	175	263	325	334	334
3. Bonded debt payable from property taxes:							
New York	22,661	126	431	555	1,295	1,873	2,566
Chicago	13,062	57	125	165	732	732	732
Philadelphia	11,946	44	160	262	373	397	797
Detroit	17,027	2	32	124	291	484	484
Los Angeles	3,716	17	60	100	171	199	200
Cleveland	3,230	33	109	157	185	191	193
St. Louis	2,092	16	59	94	135	135	135
Baltimore	3,382	15	61	92	154	199	218
Boston	2,459	45	129	176	205	213	224
Pittsburgh	5,063	26	106	159	254	310	310
San Francisco	1,721	11	47	78	114	130	133
Milwaukee	2,114	26	72	96	100	100	100
Buffalo	2,765	28	98	148	183	188	188

[1] For specifications see table 1.

Source: Treasury Department, Division of Tax Research.

TABLE 5.—*Estimated increase in annual interest costs on the present bonded debt (including overlapping debt) of cities having a population of over 500,000, at selected future dates, as a percent of 1938 interest costs, assuming that the taxation of future issues of municipal securities will result in a one-fourth of 1 percent increase in interest rates* [1]

[Money figures in thousands; percents in units of 1 percent]

City area	Interest cost 1938	Estimated increase in interest costs as a percent of 1938 interest costs, by—					
		1940	1945	1950	1960	1970	Year of final maturity
1. Total bonded debt:							
New York	$94,286	0.30	0.96	1.29	2.91	4.41	6.55
Chicago	20,261	.50	1.22	1.67	5.78	5.78	5.78
Philadelphia	26,239	.30	1.12	1.84	2.61	2.77	5.90
Detroit	29,855	.03	.34	.95	2.04	3.19	3.19
Los Angeles	12,442	.49	1.76	3.09	5.51	7.05	8.46
Cleveland	7,568	.75	2.50	3.77	4.44	4.64	4.70
St. Louis	3,600	.74	2.97	4.54	6.11	6.11	6.11
Baltimore	7,700	.40	1.58	2.49	4.40	5.62	6.03
Boston	8,050	.94	3.01	4.35	5.76	6.61	7.74
Pittsburgh	6,425	.51	2.09	3.11	4.92	5.96	5.96
San Francisco	7,726	.38	1.63	2.83	4.67	5.92	6.17
Milwaukee	3,057	1.21	3.30	4.45	4.71	4.71	4.71
Buffalo	5,692	.93	3.27	4.88	6.34	6.66	6.66
2. Bonded debt payable from general revenues							
New York	36,532	.56	1.91	2.45	5.71	8.26	11.32
Chicago	18,904	.44	.96	1.26	5.61	5.61	5.61
Philadelphia	16,606	.37	1.34	2.19	3.12	3.32	6.67
Detroit	23,952	.01	.19	.73	1.71	2.84	2.84
Los Angeles	5,896	.46	1.61	2.70	4.61	5.36	5.33
Cleveland	4,859	1.03	3.38	4.86	5.72	5.91	5.99
St. Louis	2,803	.78	2.82	4.53	6.46	6.46	6.46
Baltimore	5,253	.46	1.81	2.70	4.55	5.90	6.43
Boston	3,203	1.81	5.28	7.15	8.34	8.65	9.09
Pittsburgh	6,021	.51	2.09	3.14	5.02	6.13	6.13
San Francisco	2,481	.64	2.74	4.61	6.61	7.54	7.74
Milwaukee	2,883	1.25	3.40	4.34	4.75	4.75	4.75
Buffalo	4,906	.99	3.57	5.30	6.62	6.81	6.81
Bonded debt payable from property taxes:							
New York	22,661	.56	1.90	2.45	5.71	8.27	11.32
Chicago	13,062	.44	.96	1.26	5.60	5.60	5.60
Philadelphia	11,946	.37	1.34	2.19	3.12	3.32	6.67
Detroit	17,027	.01	.19	.73	1.71	2.84	2.84
Los Angeles	8,716	.46	1.61	2.69	4.60	5.36	5.38
Cleveland	3,230	1.02	3.37	4.86	5.73	5.91	5.98
St. Louis	2,092	.76	2.82	4.49	6.45	6.45	6.45
Baltimore	8,382	.44	1.80	2.72	4.55	5.88	6.45
Boston	2,459	1.83	5.25	7.16	8.84	8.66	9.11
Pittsburgh	5,063	.51	2.09	3.14	5.02	6.12	6.12
San Francisco	1,721	.64	2.73	4.53	6.62	7.55	7.73
Milwaukee	2,114	1.23	3.41	4.54	4.73	4.73	4.73
Buffalo	2,765	1.01	3.54	5.35	6.62	6.80	6.80

[1] For specifications see table 1.

Source: Treasury Department, Division of Tax Research.

TABLE 6.—*Estimated per capita increase in annual interest costs on the present bonded debt (including overlapping debt) of cities having a population of over 500,000, at selected future dates, assuming that the taxation of future issues of municipal securities will result in a one-fourth of 1 percent increase in interest rates* [1]

City area	Estimated per capita increase in annual interest costs by—					
	1940	1945	1950	1960	1970	Year of final maturity
1. Total bonded debt:						
New York	$0.01	$0.13	$0.17	$0.38	$0.57	$0.86
Chicago	.03	.07	.10	.34	.34	.34
Philadelphia	.04	.16	.24	.35	.37	.78
Detroit	.01	.06	.17	.36	.57	.57
Los Angeles	.05	.16	.28	.51	.65	.78
Cleveland	.06	.21	.31	.37	.38	.39
St. Louis	.03	.13	.19	.26	.26	.26
Baltimore	.04	.15	.24	.41	.53	.57
Boston	.10	.31	.44	.59	.68	.79
Pittsburgh	.05	.20	.29	.47	.56	.56
San Francisco	.04	.19	.33	.55	.70	.73
Milwaukee	.06	.17	.23	.24	.24	.24
Buffalo	.09	.32	.48	.62	.65	.66
2. Bonded debt payable from general revenues:						
New York	.03	.10	.13	.29	.42	.58
Chicago	.02	.05	.07	.31	.31	.31
Philadelphia	.03	.11	.18	.26	.28	.56
Detroit	.002	.03	.10	.25	.41	.41
Los Angeles	.02	.07	.12	.20	.23	.23
Cleveland	.05	.18	.26	.30	.31	.32
St. Louis	.03	.10	.15	.22	.22	.22
Baltimore	.03	.12	.17	.29	.38	.41
Boston	.07	.21	.29	.34	.35	.37
Pittsburgh	.05	.19	.28	.45	.54	.54
San Francisco	.02	.10	.17	.25	.29	.29
Milwaukee	.06	.16	.22	.23	.23	.23
Buffalo	.08	.30	.45	.56	.57	.57
3. Bonded debt payable from property taxes:						
New York	.02	.06	.08	.18	.26	.36
Chicago	.02	.04	.05	.21	.21	.21
Philadelphia	.02	.09	.13	.19	.20	.40
Detroit	.001	.02	.07	.17	.29	.29
Los Angeles	.01	.04	.07	.13	.15	.15
Cleveland	.04	.12	.17	.20	.21	.21
St. Louis	.02	.07	.11	.16	.16	.16
Baltimore	.02	.07	.11	.19	.24	.27
Boston	.06	.16	.22	.26	.27	.28
Pittsburgh	.04	.16	.23	.37	.46	.46
San Francisco	.02	.07	.12	.17	.20	20
Milwaukee	.04	.12	.16	.17	.17	.17
Buffalo	.05	.17	.25	.31	.32	.32

[1] Computed on the basis of population in 1933, the year last reported by the Bureau of the Census. For other specifications see table 1.

Source: Treasury Department, Division of Tax Research.

TABLE 7.—*Estimated property-tax rates required to finance the increased interest cost on the present bonded debt payable from property taxes (including overlapping debt) of cities having a population of over 500,000, at selected future dates, on the basis of the 1938 assessed valuation, assuming that the taxation of future issues of municipal securities will result in a one-fourth of 1 percent increase in interest rates* [1]

City area	1938 assessed valuation	Tax rate per $1,000 of assessed valuation in dollars						
		1936 actual	1940	1945	1950	1960	1970	Year of final maturity
New York	$16,650,297,791	27.14	0.0076	0.0259	0.0333	0.0778	0.1125	0.1541
Chicago	2,073,970,391	95.20	.0275	.0503	.0790	.3529	.3529	.3520
Philadelphia	3,456,332,856	20.24	.0127	.0163	.0758	.1070	.1140	.2306
Detroit	2,466,923,913	27.90	.0008	.0130	.0503	.1180	.1962	.1962
Los Angeles	1,362,464,440	32.06	.0125	.0140	.0731	.1255	.1461	.1468
Cleveland	1,184,233,400	28.61	.0279	.0920	.1320	.1562	.1613	.1630
St. Louis	1,017,564,742	26.89	.0153	.0563	.0897	.1289	.1289	.1289
Baltimore	1,959,566,191	21.60	.0077	.0311	.0169	.0786	.1016	.1112
Boston	1,550,407,800	37.74	.0290	.0832	.1135	.1322	.1374	.1445
Pittsburgh	1,008,861,670	37.14	.0237	.0965	.1417	.2311	.2821	.2821
San Francisco	971,901,210	26.70	.0113	.0184	.0803	.1173	.1338	.1338
Milwaukee	846,913,105	32.27	.0307	.0850	.1134	.1181	.1181	.1181
Buffalo	905,407,590	33.90	.0290	.1015	.1533	.1895	.1047	.1947

[1] For specifications, see table 1.

Source: Treasury Department, Division of Tax Research.

TABLE 8.—*Estimated percentage increase in 1936 property-tax rates required to finance the increased interest cost on the present bonded debt payable from property taxes (including overlapping debt) of cities having a population of over 500,000, at selected future dates, on the basis of the 1938 assessed valuation, assuming that taxation of future issues of municipal securities will result in a one-fourth of 1 percent increase in interest rates* [1]

City area	Percentage increase in 1936 tax rate in units of 1 percent					
	1940	1945	1950	1960	1970	Year of final maturity
New York	0.03	0.10	0.12	0.29	0.41	0.57
Chicago	.03	.06	.08	.37	.37	.37
Philadelphia	.06	.23	.37	.53	.57	1.14
Detroit	.003	.05	.18	.42	.70	.70
Los Angeles	.04	.14	.23	.39	.46	.46
Cleveland	.10	.32	.46	.55	.56	.57
St. Louis	.06	.21	.33	.48	.48	.48
Baltimore	.04	.14	.22	.36	.47	.51
Boston	.08	.22	.30	.35	.36	.38
Pittsburgh	.06	.26	.39	.62	.76	.76
San Francisco	.04	.18	.30	.44	.50	.50
Milwaukee	.10	.26	.35	.37	.37	.37
Buffalo	.09	.30	.45	.56	.57	57

[1] For specifications see table 1.

Source: Treasury Department, Division of Tax Research.

Exhibit E is the rest of the photostatic tables. Table 1 in exhibit E indicates the present bonded debt of cities having a population of over 500,000 and their overlapping units, showing overlapping debt allocated to cities and the distribution of the total debt by, first, debt payable from utilities and special assessments; second, debt payable from general revenues; and, third, debt payable from property taxes, and we have tried to show the assessed value of the city as to the assessed value of the county or the district.

You will note the utility revenues and special assessments are a substantial proportion of that total debt.

Now, table 2—and all of the rest of the tables are based on tables 1 and 2—shows the estimated amount of present bonded debt, including overlapping debt, with cumulative maturities and the amounts that would be retired by January 1, 1940, 1945, 1950, 1960, and 1970, and the year of final maturity, whatever that year would be.

Curiously, New York has some bonds maturing in 2147.

There are three parts to the table, one showing the total bonded debt, and the second, the bonded debt payable from general revenues, and, third, the bonded debt payable from property taxes.

Table 3 shows the percent of the present debt to be retired by each of these cities over the years. For example, in New York, 4.63 percent of the total bonded debt will be retired by 1940, and so on.

Table 4 shows the estimated increase in annual interest costs on the basis of one-quarter of 1 percent, in each of the years.

Table 5 shows the percent of increase in interest cost for each of the years.

Table 6 shows the estimated per-capita increase in interest costs.

The CHAIRMAN. This may sound like a silly question, but I do not get whether the per capita is per year or over the entire period.

Mr. BLOUGH. The annual per capita cost.

The CHAIRMAN. Just amplify that a little. On table 6, take the first in New York; state just what that means.

Mr. BLOUGH. The total bonded debt of New York City.

The CHAIRMAN. You are talking about the interest cost?

Mr. BLOUGH. The interest cost on that total bonded debt of New York would be increased by 1940 by 4 cents per capita; by 1945, the annual increased cost would be 13 cents per capita, assuming there is a differential in tax exemption. By 1950, the annual rate would be increased by 17 cents per capita.

The CHAIRMAN. You need not go any further.

Senator AUSTIN. Those are all in the same category, are they not? That is, they all represent the estimated per-capita increase in annual interest costs?

Mr. BLOUGH. Yes, sir.

Senator AUSTIN. And not the cost?

Mr. BLOUGH. By no means. That is just the increase.

Table 7 shows the increase in tax rates, that is, the estimated property tax rates required to finance the increased interest cost on the present bonded debt payable from property taxes. For instance, in New York in 1936, the tax rate was 27.14 per thousand dollars of assessed valuation. The added interest in 1940 would have been 0.0076, and in 1970 it would be 0.1125, and that would mean 27.2525 instead of 27.14.

The CHAIRMAN. It looks very small, but it looks large per capita.

Mr. BLOUGH. When you consider that the total cost of the government in the United States is running around $100 per capita, that is very small.

Table 8 shows the estimated percentage increase in property tax rates.

These cost figures have a direct bearing on the claim that it will be impossible for States and localities to refund their outstanding securities to advantage.

The greatest stress has been placed on the city which wishes to refund at current rates bonds issued some years ago when interest rates were high. In a relatively few and, for the most part, unimportant cases, cities in default desire to take advantage of opportunities to refund. In other cases, callable bonds are outstanding.

However, the proportion of bonds that is callable is small, probably not over 10 percent of those oustanding.

In any event, the elimination of tax exemption should not make profitable refunding impossible or markedly less advantageous. The average or composite coupon rate on municipal bonds issued in 1929, for instance, was 4.72 percent.

The CHAIRMAN. What was the approximate difference between the total outstanding issues in 1929 and 1936?

Mr. BLOUGH. In 1929, the cities and the localities had interest-bearing debts of $16,760,000,000, according to the Treasury report, and in 1936, they had $19,170,000,000.

Senator BYRD. What is the figure with respect to the Federal Government?

Mr. BLOUGH. With respect to the Federal Government, the United States Government, not including farm loans, R. F. C., Federal Home loans, and so on, in 1929 there was outstanding $16,639,000,000, and in 1938, at the same time, $36,579,000,000. These figures are taken from exhibit F, which is inserted at the end of my testimony.

Senator BYRD. I ask for this information for another matter, but has the Treasury Department got available all of the bonds and securities issued by these Federal corporations?

Mr. BLOUGH. You mean, have we a statement on that?

Senator BYRD. Yes.

Mr. BLOUGH. That was included in the Under Secretary's statement before this committee, previously, and the securities outstanding is found on page 19 of the printed copy.

Does that contain the information you desire?

Senator BYRD. What is the total?

Mr. BLOUGH. The total of the Federal agencies and instrumentalities, the total outstanding is $7,989,000,000, making a total of United States Government and Federal agencies and instrumentalities, on June 30, 1938, of $44,568,000,000.

Senator BYRD. Of course, that must be regarded as much a debt as the direct obligation of the Government, for it is wholly guaranteed by the Federal Government.

Mr. BLOUGH. Most of these are guaranteed obligations.

Senator BYRD. As a matter of fact, in reaching the total indebtedness, they should be regarded as obligations of the Government.

Mr. BLOUGH. I do not feel competent to state what they should be regarded as.

The CHAIRMAN. They are contingent liabilities.

Senator BYRD. I am not sure these are highly contingent liabilities. These corporations have no stock except what the Government owns.

The CHAIRMAN. Take, for instance, the Home Owners' Loan Corporation. Of course, I think there is going to be a loss, which we may have to pay. Of course, a great many might default, but still the obligations of the Government by no means will be $2,000,000,000.

Senator BYRD. I fully recognize that, but as obligations of the Government, it has guaranteed payment on it, and assuming that those recoverable items were paid into the Home Owners' Loan Corporation, it might be that a great part will not be paid until the greater part of the Home Owners' Loan securities mature.

The CHAIRMAN. It does not seem to me to be quite fair to assume that they are in the same class of debt as the general obligations of the Treasury. If that were so, we must pay 100 cents on the dollar, but we are only liable for whatever amount the home owners default. I say it is the same difference as in a case of my own; if I absolutely owed $10,000 to the bank, that is an obligation of my own; but, if I am on your note for $5,000, I expect you to pay it.

Senator BYRD. I agree, of course, that as such sums as are recoverable, they should be regarded as an asset, but the point I make is that it is still an obligation of the Federal Government.

The CHAIRMAN. Yes; it is a contingent obligation.

Senator BYRD. And I wanted to suggest at the proper time to Mr. Hanes, or whoever has charge of it, that the Treasury Department make a statement as to the contingent liability at the same time they show the direct liability.

Mr. MURPHY. The contingent liability is included in the statement as soon as we are able to complete the data.

Senator BYRD. You say that is included?

Mr. MURPHY. Contingent liabilities are not included in the preliminary statement of the public debt, but are reported in a separate schedule in the final statement of the public debt.

The CHAIRMAN. That is issued about four times a year.

Mr. MURPHY. The final statement of the public debt is issued monthly, but, due to the fact that it must be complete and contain all of the items in transit, it is in arrears. For instance, during the bonus bonds period, when there were millions of individual items, it was several months in arrears, but normally we try to issue it not more than about 3 months in arrears.

Senator TOWNSEND. When was the last one issued?

Mr. MURPHY. I believe the last one covered November 30, but I would have to check.

Mr. BLOUGH. The average or composite coupon rate on municipal bonds issued in 1936 was 3.09 percent. The spread from 1929 to 1936 is 1.63 percent, which is far wider than even the most ambitious estimate of the differential due to tax exemption. It is suggested that the elimination of the tax-exemption privilege cannot seriously detract from otherwise profitable refunding operations.

A very general complaint against eliminating tax exemption has been that housing projects and other municipal works cannot be carried on so cheaply if securities are taxable. This is freely admitted, although we believe the differential and probable effects to be much lower than was stated by persons presenting statements on this point.

However, there are two reasons why the present subsidy through tax exemption is undesirable. The first is that, as previously pointed out, if a subsidy is to be made it would be better to have it made in cash where it can be brought out into the open and seen than to have it made a hidden form through tax exemption.

The second reason is that the local public, in deciding whether a project involving the expenditure of public funds is desirable and in choosing between financing it out of current taxes or by borrowing, is influenced by the existence of reduced rates of interest due to the tax-exemption subsidy. To bring a more accurate choice by the public between governmental and private spending and between bond and tax financing, the project should stand on its own feet, without benefit of special encouragement through a tax-exemption subsidy.

In summary, it is my contention:

(1) That the existence of tax-exempt securities does severely undermine the progressive feature of the income tax;

(2) That tax exemption enjoyed by holders of public securities results in increased burdens upon those in the lower income groups;

(3) That the increases in income tax revenue resulting from discontinuing the issuance of tax-exempt securities will substantially exceed probable increases in interest costs;

(4) That these probable increases in interest costs will be less than those suggested by witnesses opposed to this proposal;

(5) That the effects of these increased interest costs will be felt only gradually, as the present debt is replaced by taxable issues;

(6) That only a fraction of these increased costs will fall on general property; and finally,

(7) That the subsidy provided by tax exemption to such public projects as housing has undesirable aspects and its elimination therefore is not as great a public loss as is generally alleged.

These conclusions are based, in part, on the Treasury estimates of interest differentials due to tax exemption, and of revenues to be derived from discontinuing the issuance of tax-exempt securities. These estimates will be discussed by members of the Treasury technical staff who are specialists in the subject.

I apologize for taking up so much of your time.

The CHAIRMAN. It is perfectly all right.

(Exhibit F above referred to is as follows:)

EXHIBIT F. TAX-EXEMPT SECURITIES

TABLE 1.—*Estimated amount of securities outstanding, interest on which is wholly or partially exempt from the Federal income tax, June 30, 1938* [1]

[In millions of dollars]

	Total [2]	Wholly exempt	Partially exempt
A. U. S. Government, Federal agencies and instrumentalities:			
1. Interest-bearing securities outstanding:			
(a) U. S. Government	36,579	13,492	23,087
(b) Federal agencies and instrumentalities	7,989	2,151	5,838
Total	44,568	15,643	28,925
2. Interest-bearing securities held by:			
(a) U. S. Government, Federal trust funds and agencies	6,465	3,621	2,844
(b) Federal Reserve banks	2,564	1,820	744
(c) State and local sinking funds	59		59
(d) State and local trust and investment funds	[3] 210		[3] 210
Total	9,298	5,441	3,857
3. Net outstanding interest-bearing securities	35,270	10,202	25,068
B State and local governments:			
1. Interest-bearing securities outstanding	19,170	19,170	
2. Interest-bearing securities held by:			
(a) U. S. Government, Federal trust funds and agencies	538	538	
(b) State and local sinking funds	1,501	1,501	
(c) State and local trust and investment funds	[3] 2,393	[3] 2,393	
Total	4,432	4,432	
3. Net outstanding interest-bearing securities	14,738	14,738	
C. Territories and insular possessions:			
1. Interest-bearing securities outstanding	146	146	
2. Interest-bearing securities held by:			
(a) Territorial and insular sinking funds	23	23	
3. Net outstanding interest-bearing securities	123	123	
D. Recapitulation:			
1. Interest-bearing securities outstanding	63,884	34,959	28,925
2. Interest-bearing securities held by:			
(a) U. S. Government, Federal trust funds and agencies	7,003	4,159	2,844
(b) Federal Reserve banks	2,564	1,820	744
(c) State and local sinking funds	1,560	1,501	59
(d) State and local trust and investment funds	[3] 2,603	[3] 2,393	[3] 210
(e) Territorial and insular sinking funds	23	23	
Total	13,753	9,896	3,857
3. Net outstanding interest-bearing securities	50,131	25,063	25,068

[1] "Total outstanding issues" of tax-exempt securities of the several borrowers differs from the gross indebtedness of these borrowers in that it excludes noninterest-bearing and taxable interest-bearing debt. "Net outstanding issues" differs from net indebtedness in that it excludes from "total outstanding issues" tax-exempt securities held by governments, governmental agencies, Federal Reserve banks, and public sinking, trust and investment funds, while net debt excludes from gross debt the total volume of sinking fund assets, regardless of their character, but ignores all other public assets.

Tax-exempt securities are segregated into 2 categories, those partially exempt and those wholly exempt. The former are exempt from the normal rates and the latter from both the normal and the surtax rates of the Federal income tax. United States savings bonds and Treasury bonds are here classified as partially tax-exempt securities. However, it is to be noted that by statutory provision, interest derived from the first $5,000 of principal amount of these securities owned by any single holder is exempt from the surtax as well as the normal tax.

The estimate of the volume of tax-exempt securities outstanding on June 30, 1938, is based in part on a questionnaire survey of State, local, territorial, and insular debt and specified funds, conducted by the Treasury Department in cooperation with the Department of the Interior Division of Territories and Island Possessions, and the War Department Bureau of Insular Affairs, and in part on the record of new security issues published by the *Commercial and Financial Chronicle*.

The estimate of the volume of tax-exempt securities outstanding in earlier years, shown in table 56, was based on a questionnaire survey conducted by the Treasury Department and upon the Bureau of the Census decennial *Financial Statistics of State and Local Governments* and annual *Financial Statistics of States* and *Financial Statistics of Cities*, as well as the statistics of new security issues and security retirements published in the *Bond Buyer* and the *State and Municipal Compendium* of the *Commercial and Financial Chronicle*.

[2] Excludes such tax-exempt securities as may be held by the stabilization fund.

[3] In the absence of Nation-wide trust and investment fund data for 1938, it was assumed that the tax-exempt security holdings of these funds increased 5 percent during the last fiscal year. This assumption was based on pre-1937 trends for States and cities and on available fragmentary data for 1938.

TABLE 2.—*Estimated amount of securities outstanding, interest on which is wholly or partially exempt from the Federal income tax, June 30, 1913 to 1938, by types of borrowers* [1]

[In millions of dollars]

A. TOTAL OUTSTANDING ISSUES

June 30—	Grand total			U. S. Government [2]			Federal Farm Loan System			Federal Home Loan System [5] (partially exempt)	Reconstruction Finance Corporation (partially exempt)	Commodity Credit Corporation (partially exempt)	Federal National Mortgage Association (partially exempt)	Territories and insular possessions (wholly exempt)	States, counties, cities, etc. (wholly exempt)
	Wholly and partially exempt	Wholly exempt	Partially exempt	Total	Wholly exempt	Partially exempt	Total	Wholly exempt [3]	Partially exempt [4]						
1913	5,531	5,531	----	966	966	----	----	----	----	----	----	----	----	37	4,528
1914	5,954	5,954	----	968	968	----	----	----	----	----	----	----	----	37	4,949
1915	6,427	6,427	----	970	970	----	----	----	----	----	----	----	----	40	5,417
1916	6,887	6,887	----	972	972	----	----	----	----	----	----	----	----	40	5,875
1917	9,049	9,049	----	2,713	2,713	----	----	----	----	----	----	----	----	46	6,290
1918	18,786	9,187	9,599	11,986	2,387	9,599	111	111	----	----	----	----	----	46	6,643
1919	32,597	10,159	22,439	25,234	2,796	22,439	274	274	----	----	----	----	----	47	7,042
1920	32,257	11,308	20,949	24,061	3,112	20,949	401	401	----	----	----	----	----	49	7,746
1921	32,724	11,922	20,803	23,737	2,935	20,803	450	450	----	----	----	----	----	61	8,476
1922	33,411	12,994	20,417	22,711	2,294	20,417	730	730	----	----	----	----	----	77	9,893
1923	33,788	14,074	19,714	22,008	2,294	19,714	1,062	1,062	----	----	----	----	----	120	10,598
1924	33,978	15,290	18,688	20,982	2,294	18,688	1,231	1,231	----	----	----	----	----	132	11,633
1925	34,681	16,645	18,036	20,211	2,175	18,036	1,506	1,506	----	----	----	----	----	134	12,830
1926	34,856	17,636	17,220	19,384	2,164	17,220	1,659	1,659	----	----	----	----	----	149	13,664
1927	34,933	18,846	16,087	18,251	2,164	16,087	1,789	1,789	----	----	----	----	----	158	14,735
1928	35,044	19,892	15,152	17,318	2,166	15,152	1,866	1,866	----	----	----	----	----	161	15,699
1929	35,428	20,957	14,471	16,639	2,168	14,471	1,867	1,867	----	----	----	----	----	162	16,760
1930	35,943	23,785	12,158	15,922	3,764	12,158	1,871	1,871	----	----	----	----	----	165	17,985
1931	37,626	25,750	11,876	16,519	4,643	11,876	1,885	1,885	----	----	----	----	----	162	19,060
1932	40,782	28,316	12,466	19,162	7,046	12,116	1,780	1,780	----	----	350	----	----	160	19,330
1933	45,109	31,499	13,610	22,158	10,133	12,025	1,694	1,694	----	----	1,585	----	----	155	19,517
1934	52,188	33,354	18,834	26,480	12,194	14,286	2,499	2,187	312	746	3,490	----	----	150	18,823
1935	56,939	35,080	21,859	27,646	13,565	14,081	3,625	2,399	1,226	2,647	3,905	----	----	144	18,972
1936	63,179	36,947	26,232	32,756	15,272	17,484	3,740	2,318	1,422	3,044	4,282	----	----	145	19,212
1937	65,648	36,591	29,057	35,803	15,065	20,738	3,650	2,228	1,422	3,037	3,860	----	----	146	19,152
1938	63,884	34,959	28,925	36,579	13,492	23,087	3,561	2,151	1,410	3,029	1,163	206	30	146	19,170

.B HELD BY UNITED STATES GOVERNMENT, FEDERAL TRUST FUNDS AND AGENCIES [6]

June 30—	Grand total			U. S. Government			Federal Farm Loan System			Federal Home Loan System (partially exempt)	Reconstruction Finance Corporation (partially exempt)	Commodity Credit Corporation (partially exempt)	States, counties, cities, etc. (wholly exempt)
	Wholly and partially exempt	Wholly exempt	Partially exempt	Total	Wholly exempt	Partially exempt	Total	Wholly exempt	Partially exempt				
1913	------	------	------	------	------	------	------	------	------	------	------	------	------
1914	1	1	------	1	1	------	------	------	------	------	------	------	------
1915	1	1	------	1	1	------	------	------	------	------	------	------	------
1916	2	2	------	2	2	------	------	------	------	------	------	------	------
1917	2	2	------	2	2	------	------	------	------	------	------	------	------
1918	110	61	49	53	4	49	57	57	------	------	------	------	------
1919	286	142	144	149	5	144	137	137	------	------	------	------	------
1920	373	173	200	207	7	200	166	166	------	------	------	------	------
1921	532	191	341	349	8	341	183	183	------	------	------	------	------
1922	561	147	414	422	8	414	139	139	------	------	------	------	------
1933	514	111	403	412	9	403	102	102	------	------	------	------	------
1924	489	113	376	386	10	376	103	103	------	------	------	------	------
1925	638	132	506	516	10	506	122	122	------	------	------	------	------
1926	757	141	616	626	10	616	131	131	------	------	------	------	------
1927	832	114	718	728	10	718	104	104	------	------	------	------	------
1928	925	115	810	821	11	810	104	104	------	------	------	------	------
1929	989	116	873	884	11	873	105	105	------	------	------	------	------
1930	1,079	331	748	972	224	748	106	106	------	------	------	------	------
1931	542	366	176	435	259	176	106	106	------	------	------	------	1
1932	1,027	386	641	570	279	291	106	106	------	------	------	------	1
1933	2,368	531	1,837	651	399	252	106	106	------	------	350	------	1
1934	5,115	1,051	4,064	1,254	581	673	444	317	127	9	1,585	------	26
1935	6,884	2,046	4.838	1,586	772	814	1,126	928	198	171	3,255	------	153
1936	7,632	2,093	5,539	1,876	752	1,124	1,116	919	197	188	3,655	------	346
1937	8,543	3,034	5,509	3,180	1,671	1,509	1,013	835	178	217	4,030	------	422
1938	7,003	4,159	2,844	4,406	2,774	1,632	990	847	143	204	3,605	------	528
											864	1	538

[1] See footnote 1 on p. 543.
[2] On basis of daily Treasury statements (revised), see p. 351.
[3] Includes Federal land bank bonds (both those issued by the individual banks and the consolidated series), Federal intermediate credit bank debentures, and joint stock land bank bonds. Does not include stocks.
[4] Federal Farm Mortgage Corporation bonds.
[5] Includes Home Owners' Loan Corporation bonds and home loan bank debentures.
[6] Excludes stabilization fund and Federal Reserve banks.

TABLE 2.—*Estimated amount of securities outstanding, interest on which is wholly or partially exempt from the Federal income tax, June 30, 1913 to 1938, by types of borrowers*—Continued

[In millions of dollars]

C. HELD BY FEDERAL RESERVE BANKS

June 30—	U. S. Government			June 30—	U. S. Government			June 30—	U. S. Government		
	Total	Wholly exempt	Partially exempt		Total	Wholly exempt	Partially exempt		Total	Wholly exempt	Partially exempt
1913	----	----	----	1922	555	17	538	1931	668	451	217
1914	----	----	----	1923	102	12	90	1932	1,784	1,422	362
1915	8	8	----	1924	431	6	425	1933	1,998	1,582	416
1916	57	57	----	1925	353	3	350	1934	2,432	1,990	442
1917	66	66	----	1926	385	3	382	1935	2,433	2,143	290
1918	255	58	197	1927	370	3	367	1936	2,430	2,115	315
1919	292	25	267	1928	235	3	232	1937	2,526	1,794	732
1920	341	25	316	1929	216	3	213	1938	2,564	1,820	744
1921	259	22	237	1930	591	301	290				

D. HELD IN SINKING FUNDS AND TRUST AND INVESTMENT FUNDS OF STATES, LOCALITIES, TERRITORIES, AND INSULAR POSSESSIONS

(A) HELD IN SINKING FUNDS

June 30—	Total	U. S. Government (partially exempt)	States, counties, cities, etc. (wholly exempt)	Territories and insular possessions (wholly exempt)	June 30—	Total	U. S. Government (partially exempt)	States, counties, cities, etc. (wholly exempt)	Territories and insular possessions (wholly exempt)	June 30—	Total	U. S. Government (partially exempt)	States, counties, cities, etc. (wholly exempt)	Territories and insular possessions (wholly exempt)
1913	621	----	620	1	1922	1,329	----	1,328	1	1931	2,155	----	2,141	14
1914	670	----	669	1	1923	1,508	----	1,506	2	1932	1,472	50	1,399	23
1915	736	----	735	1	1924	1,634	----	1,627	7	1933	1,492	51	1,417	24
1916	794	----	793	1	1925	1,762	----	1,753	9	1934	1,513	52	1,436	25
1917	861	----	860	1	1926	1,904	----	1,889	15	1935	1,534	54	1,454	26
1918	950	----	949	1	1927	2,037	----	2,020	17	1936	1,554	55	1,473	26
1919	1,053	----	1,052	1	1928	2,151	----	2,139	12	1937	1,578	61	1,491	26
1920	1,081	----	1,080	1	1929	2,296	----	2,281	15	1938	1,583	59	1,501	23
1921	1,094	----	1,090	4	1930	2,431	----	2,418	13					

(B) Held in Trust and Investment Funds

1937	[7] 2,479	200	2,279	----------	1938 [8]	2,603	210	2,393	----------	----------	----------	----------	----------	----------

E. NET OUTSTANDING ISSUES [9]

June 30—	Grand total			U. S. Government			Federal Farm Loan System			Federal Home Loan System (partially exempt)	Reconstruction Finance Corporation (partially exempt)	Commodity Credit Corporation (partially exempt)	Federal National Mortgage Association (partially exempt)	Territories and insular possessions (wholly exempt)	States, counties, cities, etc. (wholly exempt)
	Wholly and partially exempt	Wholly exempt	Partially exempt	Total	Wholly exempt	Partially exempt	Total	Wholly exempt	Partially exempt						
1913	4,910	4,910	----------	966	966	----------	----------	----------	----------	----------	----------	----------	----------	36	3,908
1914	5,283	5,283	----------	967	967	----------	----------	----------	----------	----------	----------	----------	----------	36	4,280
1915	5,682	5,682	----------	961	961	----------	----------	----------	----------	----------	----------	----------	----------	39	4,682
1916	6,034	6,034	----------	913	913	----------	----------	----------	----------	----------	----------	----------	----------	39	5,082
1917	8,120	8,120	----------	2,645	2,645	----------	----------	----------	----------	----------	----------	----------	----------	45	5,430
1918	17,471	8,118	9,353	11,678	2,325	9,353	54	54	----------	----------	----------	----------	----------	45	5,694
1919	30,967	8,939	22,028	24,794	2,766	22,028	137	137	----------	----------	----------	----------	----------	46	5,990
1920	30,462	10,029	20,433	23,513	3,080	20,433	235	235	----------	----------	----------	----------	----------	48	6,666
1921	30,840	10,615	20,225	23,130	2,905	20,225	267	267	----------	----------	----------	----------	----------	57	7,386
1922	30,966	11,501	19,465	21,734	2,269	19,465	591	591	----------	----------	----------	----------	----------	76	8,565
1923	31,664	12,443	19,221	21,494	2,273	19,221	960	960	----------	----------	----------	----------	----------	118	9,092
1924	31,424	13,537	17,887	20,165	2,278	17,887	1,128	1,128	----------	----------	----------	----------	----------	125	10,006
1925	31,928	14,748	17,180	19,342	2,162	17,180	1,384	1,384	----------	----------	----------	----------	----------	125	11,077
1926	31,810	15,588	16,222	18,373	2,151	16,222	1,528	1,528	----------	----------	----------	----------	----------	134	11,775
1927	31,694	16,692	15,002	17,153	2,151	15,002	1,685	1,685	----------	----------	----------	----------	----------	141	12,715
1928	31,733	17,623	14,110	16,262	2,152	14,110	1,762	1,762	----------	----------	----------	----------	----------	149	13,560
1929	31,927	18,542	13,385	15,539	2,154	13,385	1,762	1,762	----------	----------	----------	----------	----------	147	14,479
1930	31,842	20,722	11,120	14,359	3,239	11,120	1,765	1,765	----------	----------	----------	----------	----------	152	15,566
1931	34,261	22,778	11,483	15,416	3,933	11,483	1,779	1,779	----------	----------	----------	----------	----------	148	16,918
1932	36,499	25,086	11,413	16,758	5,345	11,413	1,674	1,674	----------	----------	----------	----------	----------	137	17,930
1933	39,251	27,945	11,306	19,458	8,152	11,306	1,588	1,588	----------	----------	----------	----------	----------	131	18,074
1934	43,128	28,852	14,276	22,742	9,623	13,119	2,055	1,870	185	737	235	----------	----------	125	17,234
1935	46,088	29,411	16,677	23,573	10,650	12,923	2,499	1,471	1,028	2,476	250	----------	----------	118	17,172
1936	51,563	31,240	20,323	28,395	12,405	15,990	2,624	1,399	1,225	2,856	252	----------	----------	119	17,317
1937 [10]	50,522	27,967	22,555	29,836	11,600	18,236	2,637	1,393	1,244	2,820	255	----------	----------	120	14,854
1938 [10]	50,131	25,063	25,068	29,340	8,898	20,442	2,571	1,304	1,267	2,825	299	205	30	123	14,738

[7] Data for earlier years not available.
[8] See footnote 3 on p. 543.
[9] Total outstanding issues less those held by U. S. Government, Federal trust funds and agencies, Federal Reserve banks, and in sinking funds of States, localities, territories, and insular possessions. See also footnote 1 on p. 543.
[10] After deduction of tax-exempt securities held in State and local trust and investment funds; data for earlier years not available.

Senator BYRD. There is another question I would like to ask. Mr. Lutz gave a statement of his estimate, the receipts and the cost. Have you got something comparable to that?

Mr. BLOUGH. Yes, sir. I think you will find it in the original hearing, on page 10; the hearing on the taxation of governmental securities and salaries, the print. And I think I have summarized those figures in the statement that I read here.

Senator TOWNSEND. Can you state the difference?

Mr. BLOUGH. I would rather leave that to Mr. O'Donnell, who is the person that makes the Federal estimates.

It is out of my field.

Has the Committee any other questions to ask?

The CHAIRMAN. I have none.

Senator BYRD. It is a very interesting statement.

The CHAIRMAN. We will now hear from Mr. Murphy.

(The following letter and memorandum from Mr. Hanes, Under Secretary of the Treasury, was submitted:)

TREASURY DEPARTMENT,
Washington, February 20, 1939.

Hon. PRENTISS M. BROWN,
Chairman, Special Committee of the Senate on Taxation of Governmental Securities and Salaries,
United States Senate, Washington, D. C.

MY DEAR SENATOR: In accordance with your request on the occasion of my appearance before the Special Committee of the Senate on Taxation of Governmental Securities and Salaries, I take pleasure in transmitting, herewith a memorandum on, "The probable effects of discontinuing the issuance of tax-exempt securities on the refunding operations of State and local governments, with some consideration of possible relief provisions."

Sincerely yours,

JOHN W. HANES,
Under Secretary of the Treasury.

FEBRUARY 20, 1939.

MEMORANDUM ON THE PROBABLE EFFECTS OF DISCONTINUING THE ISSUANCE OF TAX-EXEMPT SECURITIES ON THE REFUNDING OPERATIONS OF STATE AND LOCAL GOVERNMENTS, WITH SOME CONSIDERATION OF POSSIBLE RELIEF PROVISIONS

SUMMARY

1. Bonds issued for the purpose of refunding outstanding obligations generally comprise a small proportion of total State and local security flotations. In recent years the volume of refunding issues has been abnormally high because (*a*) the low rates prevailing in the money markets made profitable the refunding of callable bonds at lower rates than originally issued, (*b*) some municipalities in financial distress went through financial reorganization which involved refunding operations, and (*c*) some governments having made inadequate sinking fund provisions, were unable to meet the maturing principal repayments and postponed the burden of retirement by refunding operations.

2. Insofar as the taxation of interest derived from future issues of public securities will result in increased interest rates, refunding operations will become less attractive. This, however, is not believed to be an important consideration from the point of view of State and local governments in general.

(*a*) With regard to the refunding of callable bonds the volume is likely to be small because only a small fraction of State and local bonds carry the "call" feature. Moreover, recent declines in interest rates have been so marked that notwithstanding some increases in the cost of borrowing, the refunding of callable bonds will continue to be profitable.

(*b*) With regard to the refunding operations of municipalities in financial distress, it is noted (i) that the Reconstruction Finance Corporation's refunding of the indebtedness of distressed agricultural districts will not be affected because the taxable status of interest paid on these securities is of little significance, and

(ii) that the volume of State and local debt involved in default of interest or principal has at no time during the recent depression been large and has already been corrected to a substantial degree.

(c) With respect to refunding operations resulting from deficits of sinking funds, it is noted that the volume of such refunding will probably be small in the future because of the steady swing away from "term" to "serial" bonds, and because of more stringent regulation of sinking-fund practices.

3. While the adverse effect of the proposed legislation on State and local refunding operations would not be as wide or as serious as has been maintained, some hardship would doubtless arise. Accordingly, it may be necessary to exempt certain types of refunding issues from the proposed legislation. However, the exemption of all refunding issues would be ill advised because (a) bona fide refunding issues cannot be readily defined, (b) such exemption would have the effect of stimulating and encouraging undesirable fiscal practices, and (c) the continued issuance of tax-exempt securities, even by a limited number of political units, would unnecessarily postpone the effectiveness of the proposed legislation.

4. Nonetheless, relief may be accorded in some instances. Among these, the following are deemed worthy of consideration:

(a) Interest paid on refunding bonds issued in exchange for bonds now outstanding might be placed in the same category as interest on securities issued prior to the enactment of the proposed legislation. However, the exemption should in no event extend beyond the time when the issues which are replaced would otherwise have matured.

(b) Exemption from the proposed legislation might be accorded to the interest on bonds which are offered in exchange for, or the proceeds of which are used to retire, notes or certificates of indebtedness that were issued prior to the enactment of the proposed legislation, in anticipation of floating permanent bonds and maturing not more than 2 years from the date of issuance. However, such tax exemption should in no event extend beyond the maximum period for which State and municipal securities may be issued under State constitutional and statutory provisions in effect at the time of passage of the proposed legislation.

(c) Exemption might be accorded bonds issued by jurisdictions under a plan of composition for their indebtedness approved by Federal bankruptcy court in a proceeding under title IX of the Bankruptcy Act, pursuant to a petition filed in such court prior to the enactment of the proposed legislation. However, such tax exemption should in no event extend beyond the maximum period for which State and municipal securities may be issued under State constitutional and statutory provisions in effect at the time of passage of the proposed legislation.

DISCUSSION

Several of the witnesses appearing before the Special Committee of the Senate on Taxation of Governmental Securities and Salaries expressed the view that if the issuance of tax-exempt securities is discontinued, the refunding operations of State and local governments may be seriously affected.[1] It is the purpose of this memorandum to examine the probable effects of discontinuing the issue of tax-exempt securities on refunding operations and to indicate some relief provisions that may be provided to alleviate hardships.

1. THE VOLUME OF REFUNDING

Bonds issued for the purpose of refunding outstanding obligations generally comprise a small proportion of the total security flotations of State and local governments. In recent years, however, the volume of refunding issues has been abnormally high. The increase in the volume of refunding issues began in 1934. In the year immediately preceding, the annual volume amounted to only $37,000,000. Thereafter it increased to $136,000,000 in 1934, $365,000,000 in 1935 and reached a peak of $382,000,000 in 1936. In that year refunding issues represented 34 percent of all new issues. Since 1936, however, refunding opera-

[1] Mr. Carl H. Chatters, executive director of the Municipal Finance Officers' Association, maintained that if the tax exemption feature of future issues of bonds is discontinued it will "make refunding impossible or unprofitable for the public bodies still in default and least able to make satisfactory refunding arrangements." Mr. Chatters goes on to say, "The drainage, levee, and irrigation district debts which the Reconstruction Finance Corporation has assisted in scaling and refinancing would be directly concerned." This class of refunding is discussed below, but it may be here noted that the tax status of these bonds is of little interest to the Reconstruction Finance Corporation. Mr. Frank C. Ferguson, Chairman of the Port of New York Authority, was less emphatic but pointed out that 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."

tions have been declining in importance, amounting in 1937 and 1938 to only one-half and one-third of the 1936 total, respectively.

Prior to the thirties, the annual volume of refunding issues never amounted to as much as $50,000,000. During the first two decades of the century the average annual volume approximated $17,000,000 and during the next 10-year period, $29,000,000. Summary totals are presented in table 1. Corresponding data for each of the years from 1901 to date will be found in exhibit A.

TABLE 1.—*State and local bond issues*

Years	Total issues	Refunding issues	
		Amount	Percent of total issues
1901-10	$2,268,774,000	$168,979,000	7.45
1911-20	4,738,938,000	174,211,000	3.68
1921-30	13,379,786,000	291,450,000	2.18
1931-38 [1]	7,905,476,000	1,389,464,000	17.58

[1] Data for 1938 preliminary.

Source: The Commercial and Financial Chronicle.

Several factors contributed to the abnormally high volume of State and local refunding in recent years. The State and local bonds which matured during these years found some governments in financial straits and unable to meet the principal payments coming due. Refunding operations enabled such units to postpone at least some part of the burden of retirements. A second contributing factor consisted of the low rates prevailing in the money markets. Between 1929 and 1936 the average coupon rate on municipal bond issues declined 1.6 points. This made profitable the refunding of callable bonds originally issued at substantially higher rates. Finally, some municipalities defaulted on either or both of interest and principal of their indebtedness. This led to financial reorganization and generally involved refunding operations at lower coupon rates and with extended maturities.

2. COMPOSITION OF REFUNDING BONDS

State and local refunding issues consist of three general categories. They include bonds issued with callable features which are called prior to maturity, generally to take advantage of lower interest rates than those prevailing at the time of original issuance. The second group of refunding operations result from financial reorganization and are usually prompted by default of either or both of interest and principal. The third group, probably of little importance quantitatively, include those instances in which term bonds reach maturity but sinking-fund assets available for the repayment of the principal are inadequate, either because such assets were never provided or after being provided were diverted to other uses. These three general categories are not mutually exclusive. Refunding prompted by default, for instance, may involve bonds with callable features.

(*a*) *Callable bonds.*—Bonds issued by State and local governments are generally "noncallable"; they carry a fixed maturity date and cannot be paid off prior to that date. Those, on the other hand, which can be called for payment at the option of the debtor in advance of the maturity date—the so-called callable, optional, or redeemable bonds—are relatively unimportant and probably account for less than 10 percent of the total State and local debt. The failure of States and localities in the past to make more extensive use of the callable feature with a view to retiring the issue prior to maturity or calling the old issue and refunding it with new bonds at lower interest rates, appears to be explained in part by the opposition of investors and bond dealers. A recent analysis of the Municipal Finance Officers' Association summarizes the investors' objections to callable bonds as follows:

"Investors have five main objections to the callable bond: The optional feature introduces into an investment an uncertainty as to maturity which investors dislike; call notices are inadequate and the investors must guard against the risk of losing 6 months' interest; the bondholder may undergo added expense when his bond is called and may further lose by having to reinvest in a lower interest rate market; the call price puts a fairly definite limit on the market price; and the optional feature may jeopardize the holder's tax-exempt status." [3]

[3] Municipal Finance Officers' Association, The Call Feature in Municipal Bonds, 1938, p. 80.

The relative importance of callable issues in State and local flotations during the period from 1920 to 1936 is indicated by exhibit B. During this 17-year period, when States and municipalities sold in excess of 100,000 issues aggregating $16,546,835,400, bonds containing the optional feature accounted for only one-twentieth of the total number of issues and of the total amounts borrowed. In addition to the securities originally issued with call features, a number of municipalities which in recent years have undergone reorganization, have taken advantage of such reorganization to add the call feature to their outstanding obligations. In this manner the total supply of callable bonds was augmented. Some of the securities called in recent years were of this type. Called bonds accounted for a substantial proportion of the total volume of recent State and local refunding. This is readily apparent from table 2. In 1936, the year when total refundings reached a peak, bonds called for redemption accounted for one-half and during the preceding year for more than two-thirds of the total refunding.

TABLE 2.—*Comparison of State and municipal bonds called with bonds refunded, 1933–36*

	Bonds called for redemption	Bonds refunded
1933	$16,803,000	$37,080,000
1934	53,179,000	136,476,000
1935	208,888,000	296,009,000
1936	172,707,000	371,923,000

Source: Municipal Finance Officers' Association, The Call Feature in Municipal Bonds, p. 112.

(*b*) *Fiscal reorganization.*—It has previously been noted that some of the abnormally large volume of recent refunding resulted from financial readjustments in those cases in which either or both of interest and principal on one or more issues was in default. In those cases in which the issues in default were callable the amounts subsequently refunded are probably included with those already discussed in the preceding section. In other cases, however, the issues were not callable and were refunded with the consent of the bondholders, frequently carrying lower coupon rates or providing for postponed maturities Specific data on the quantitative importance of refunding of this character are not available. Since the units involved, however, were, with a few notable exceptions, small borrowers, the sum could not have been very large. Data on the reported number of units in default on several recent dates are presented in exhibit C.

The fact that the aggregate number of units reported to be in default has remained relatively stable should not be interpreted to mean that financial difficulties have not been cleared up in a large part of the cases. The list of State and municipal defaults has been in process of compilation over a period of several years, but in the early years coverage was incomplete. In consequence a number of the defaults which existed as early as 1933 or 1935 were not discovered and tabulated until 1938. Writing on the 1937 trend of municipal debts and defaults for the 1938 Municipal Year Book (p. 519), Carl H. Chatters and Elton D. Woolpert observed that "the decrease in the total number of defaults is an encouraging report on the health of municipal credit."

One category of units involved in the type of refunding here discussed consists of those agricultural public districts (irrigation, reclamation, levee and drainage districts) to whom Federal refunding loans were authorized by the Federal Farm Loan Act of 1933. These loans are granted by the Reconstruction Finance Corporation and usually consist of refunding outstanding issues for slightly less than 50 percent of their face value. As of December 31, 1938, Reconstruction Finance Corporation loans of $122,000,000 have been authorized and contracts entered into with some 600 public units in 26 States. Disbursements as of the same date totaled over $84,000,000 to 450 borrowers. The period of greatest loaning was from July 1, 1933, to June 30, 1936. Since that period requests for assistance declined and now only 12 applications are on file for approximately $4,000,000 of loans. The Reconstruction Finance Corporation has also refinanced some small school districts. Activity in this field, however, has been very restricted.

(*c*) *Sinking-fund deficits.*—In a more limited number of cases refunding was necessitated by the fact that when term bonds matured, funds available in the sinking funds were inadequate for the repayment of principal. In some instances where the term for which bonds may be issued is limited by legal provisions, governmental units have systematically resorted to the practice of providing inadequate sinking funds and refunding a part of the issues when they became due. Others diverted their sinking fund assets to other uses. However, information on the quantitative importance of refunding of this character is not available.

I. PROBABLE EFFECTS OF PROPOSED LEGISLATION ON REFUNDING OPERATIONS

It is readily apparent that, insofar as the taxation of interest derived from future issues of public securities will result in increased interest rates, refunding operations will become less attractive. The degree to which such increases in the cost of borrowing may follow the enactment of the proposed legislation has been discussed elsewhere. It bears repetition, however, that the volume of refunding is generally small and constitutes but a small fraction of State and local security offerings. It has already declined to one-third of the 1936 volume and seems certain to decline further in the near future.

A substantial portion (though small in actual volume) of refunding in the immediate future will probably consists of the refunding of callable bonds. The calling of optional bonds will remain attractive as long as the present low level of interest rates continues to prevail. Although no data are available regarding the bonds which were called for redemption in 1938, the volume was obviously less than that in 1936, since the total volume of refunding in that year amounted to less than the bonds called for redemption in 1936. In the near future, however, the volume of such refunding will, of necessity, be limited by the total volume of bonds which will become callable, a feature, as already pointed out, not common to municipal bonds. The situation in the next few years will thus differ from that prevailing at the beginning of the present period of low interest rates, when the supply of callable bonds was substantial as the result of the accumulations of several years. Thus, the volume of refunding of this character, which could be expected to be effected by the proposed legislation, can in no event be large.

Moreover, the elimination of tax exemption should not markedly decrease the opportunity for profitable refunding with prevailing interest rates. The coupon rates on recent State and local issues are lower than they have been at any time for more than 20 years. The average coupon rate on municipal bonds issued in 1921 was 5.4 percent. It declined to 4.7 percent by 1924 and to 3.1 percent by 1936. The average coupon rate on 1937 issues was approximately 3.3 percent. Thus, municipal bonds which were issued in 1921 and become callable from 18 to 20 years after their issuance, will have the benefit of a decline in average coupon rates of approximately 2 percent (if present money market rates continue). Those issued in the late twenties with callable features 10 to 15 years after issuance will have the benefit of average coupon rates of more than 1 percent lower than those prevailing at the time first issued. These declines in interest rates are far wider than the most alarming estimates so far advanced of the probable increase in interest rates which may result from the elimination of the tax-exemption feature on future issues of Government securities.

Some indication of the interest saving resulting from refunding of callable bonds under prevailing money market conditions can be obtained from an analysis of State and local issues called and refunded during the period 1934 through 1936. The data presented in table 3 indicate that, on the average, refunded issues carried rates of interest of 1.5 percent less than those borne by called old issues. In other words, the elimination of the tax-exemption privilege would not seriously have detracted from otherwise profitable refunding operations in the majority of instances. This is also apparent from the average coupon rates on State and local bond issues contained in exhibit D.

TABLE 3.—*Frequency distribution of differences in interest rates between bonds called and new refunding issues: 1934–36, inclusive*

Difference in coupon rates	*Number of reported instances*	Differences in coupon rates—Con.	*Number of reported instances*
0 to 0.25	4	2.01 to 2.25	6
0.26 to 0.50	7	2.26 to 2.50	6
0.51 to 0.75	8	2.51 to 2.75	3
0.76 to 1.00	8	2.76 to 3.00	4
1.01 to 1.25	10	3.01 to 3.25	2
1.26 to 1.50	17	3.26 to 3.50	1
1.51 to 1.75	8		
1.76 to 2.00	15	Total issues	99

Source: Municipal Finance Officers' Association, The Call Feature in Municipal Bonds, p. 97.

With regard to the effect of the proposed legislation on the refunding operations of municipalities in financial distress, several observations should be made. With respect to the worst cases of financial embarrassment—those of the agricultural districts—the refunding is conducted by the Reconstruction Finance Corporation, which has thus far not offered its holdings for public sale and to whom the tax-exempt feature is of little concern. Refundings of this character are not likely to be affected by the proposed legislation. With respect to possible refunding by other financially distressed political units, two other mitigating circumstances exist. Interest rates continue to be very low and such moderate increases as may result from the elimination of the tax exemption would still leave those interest rates at comparatively low levels. More important, however, is the fact that the worst cases of financial difficulty have already been cleared up. The instances that remain are minor units with small volume of indebtedness. Writing on this subject more than 2 years ago, the editor of the Bond Buyer, who compiles the available information on the extent of municipal defaults in the United States, observed that "so far as the larger cities, counties, and school districts of the country are concerned the default era is practically over."[3] During the intervening 2 years conditions have continued to improve. Elsewhere in the same article, he observes that "with very few exceptions it is the small municipalities having a comparatively insignificant aggregate of outstanding debt that are still behind with debt service payments. The reader should also keep in mind that a municipality listed as in default may have merely fallen behind to the extent of one-half year's interest or a portion of its maturing debt principal."

Refunding operations resulting from deficits of sinking funds are believed to be unimportant. Aside from "raids" upon sinking funds during the depression, the deficits occurred several years ago and in not a few instances have been corrected. Many sinking funds now are subject to adequate State supervision or charter regulation, or judicial injunction in event of inadequate tax levies. Perhaps more important is the pronounced "swing" toward the State and local use of serial bonds and the gradual abandonment of term bonds. The sinking fund or term bond is being used to a less extent and now plays a relatively minor role in State and local debt redemptions. Even New York State and New York City (which account for 31 percent of all State and local sinking fund assets) provide by constitution or charter that all future bonds must be issued in serial form.

4. POSSIBLE RELIEF PROVISIONS

The data presented above tend to indicate that the adverse effects of the proposed legislation on State and local refunding operations would by no means be as wide and as serious as some have maintained. It should not be inferred, however, that no hardships would arise, since in some instances the inability to issue securities, interest on which is exempt from income taxation, may handicap refunding operations. To provide relief to such State and local governments, some exemptions from the proposed legislation may be warranted. In granting such exemption, however, caution should be exercised that relief thereby is not accorded political units not entitled to it. In view of the difficulties involved in differentiating between bona fide refunding operations and those prompted solely by the desire to profit from statutory exemptions, broad relief provisions would be likely to lead to abuse of legislative intent.

Furthermore, exemptions should not be so drawn as to have the effect of stimulating and encouraging undesirable fiscal practices. Thus, if all refunding issues were permitted to carry tax-exemption features, sinking fund deficits and defaults might be encouraged. Where sinking fund deficits accumulate, they are largely due to local mismanagement and have no proper claim to relief from national legislation required in the public interest. Moreover, if no limitations were placed upon the final maturity of issues exempt from the proposed legislation, long maturities would be encouraged and the effectiveness of the proposed legislation undesirably postponed. Nonetheless, some relief provisions seem warranted. These are hereafter indicated.

(a) *Refunding within original maturity limits.*—Since the proposed legislation is confined to future issues of securities and involves the continuance of the exemption privilege on those issues outstanding at the time of the enactment of the legislation, it can reasonably be maintained that interest on past bond issues should be exempt until the original maturity date whether derived from these bonds in their original form or in a refunded form. Bondholders who invested

[3] Sander Shanks, Jr., Municipal Bond Defaults, in National Municipal Review, 1937, p. 296.

in municipal securities in the belief that the income from such securities would be exempt from taxation should not be deprived of the tax exemption privilege by virtue of the fact that the financial condition of the borrowing unit requires refunding. The merit of this argument is weakened in the case of callable bonds to the extent that the possibility of the discontinuance of tax exemption by the calling date may have been anticipated and discounted at the time investment in such securities was made.

On balance, there appears to be good reason for a relief provision. Exemption from the proposed legislation may be accorded those security issues which represent refunding prior to their maturity of obligations already outstanding. Such relief could be afforded by providing that interest paid on refunding bonds issued in exchange for other bonds be in the same category as interest on securities issued prior to the enactment of the proposed legislation. Such tax exemption, however, should in no event extend beyond the time when the issues which is replaced would otherwise have matured. A relief provision of this character would enable some State and local governments to refund their callable term bonds with issues enjoying tax exemption. Thus the block of Detroit callable term bonds with final maturities in 1962–63, amounting to approximately $80,000,000, could be refunded with issues which continue to enjoy tax exemption for a period of almost 25 years. Similarly the $18,000,000 maturing in 1959–60 could be refunded with issues enjoying tax exemption for approximately 20 years.

(b) *Funding bond anticipatory notes.*—In some instances State and local governments issue temporary short-term notes to finance public-improvement programs, in anticipation of subsequent funding operations. Such temporary financing is generally prompted by the desire to postpone permanent financing until money market conditions are more favorable or until the actual cost of the public improvement is definitely established. In other cases it is prompted by the desire to postpone provision for debt service in the budget. Where temporary financing of this character has been employed, the planning and the initiation of the public project may have taken into account the effect of the tax-exemption privilege upon the cost of borrowing. The denial of that privilege after the project has been initiated and possibly completed may produce undue hardship. Consideration may therefore be given to the desirability of permitting such financing to be completed on the original basis.

To eliminate hardship of this kind, it may be provided that in those instances in which bonds are issued in exchange for, or the proceeds of which are used to retire, notes or certificates of indebtedness issued prior to the enactment of the proposed legislation in anticipation of the issuance of the permanent bonds and maturing not more than 2 years from the date of issuance, the same tax privileges may be granted for the issuance of such permanent bonds as those issued prior to the enactment of the proposed legislation. Interest on such bonds, in other words, would be in the same category as interest paid on bonds already outstanding. Such tax exemption, however, should in no event extend beyond the maximum period for which State and municipal securities may be issued under State constitutional and statutory provision in effect at the time of passage of the proposed legislation.

(c) *Refunding by municipalities which have filed petitions under chapter IX of the Federal Bankruptcy Act, as adopted August 16, 1937.*—Sections 81, 82, 83, and 84 of the Bankruptcy Act, as adopted August 16, 1937 (50 Stat. 653), and now appearing as chapter IX of the Bankruptcy Act as generally amended in 1938, empower Federal bankruptcy courts to pass upon petitions by State taxing agencies or instrumentalities for the composition of their indebtedness. The plan of composition must be approved by creditors holding not less than a specified percentage of the securities affected by the plan and cannot be confirmed unless accepted by creditors holding a specified percentage of the aggregate indebtedness of the taxing agency or instrumentality. In order that the refunding operations of jurisdictions, whose plans for financial reorganization under the Bankruptcy Act have substantially advanced prior to the enactment of the proposed legislation, may not be interfered with, a special relief provision may be desirable.

Such relief could be afforded by providing that interest paid on all bonds issued by jurisdictions under a plan of composition for their indebtedness and approved by a Federal bankruptcy court in a proceeding under chapter IX of the Bankruptcy Act, pursuant to a petition filed in the court prior to the enactment of the proposed legislation, shall be in the same category as interest on securities issued prior to the enactment of the proposed legislation. Such tax exemption, however, should in no event extend beyond the maximum period for which State and municipal securities may be issued under State constitutional or statutory provision in effect at the time of passage of the proposed legislation.

EXHIBIT A.—*State and local bond issues, showing total issues and refunding issues, 1901–38*

Year	Total	Refunding		Year	Total	Refunding	
		Amount	Percent of total			Amount	Percent of total
1901	$131,649,000	$16,731,000	12.7	1920	$683,188,000	$11,423,000	1.7
1902	148,461,000	22,309,000	15.0	1921	1,208,708,000	9,152,000	.8
1903	152,281,000	13,234,000	8.7	1922	1,101,917,000	29,816,000	2.7
1904	250,755,000	11,850,000	4.7	1923	1,063,120,000	20,002,000	1.9
1905	183,080,000	16,701,000	9.1	1924	1,398,953,000	19,315,000	1.4
1906	201,743,000	23,884,000	11.8	1925	1,399,638,000	47,545,000	3.4
1907	227,643,000	10,088,000	4.4	1926	1,365,057,000	21,517,000	1.6
1908	313,798,000	16,785,000	5.4	1927	1,509,583,000	34,617,000	2.3
1909	339,425,000	18,460,000	5.4	1928	1,414,785,000	34,796,000	2.6
1910	320,036,000	18,935,000	5.9	1929	1,430,651,000	21,645,000	1.5
1911	396,860,000	17,602,000	4.4	1930	1,487,313,000	53,015,000	3.6
1912	386,552,000	14,872,000	3.9	1931	1,256,255,000	60,636,000	4.8
1913	403,247,000	27,012,000	6.7	1932	849,460,000	87,000,000	10.2
1914	474,074,000	9,347,000	2.0	1933	520,478,000	37,080,000	7.1
1915	498,558,000	32,124,000	6.4	1934	939,454,000	136,476,000	14.5
1916	457,141,000	23,406,000	5.1	1935	1,220,150,000	365,150,000	29.9
1917	451,279,000	15,405,000	3.4	1936	1,117,352,000	382,443,000	34.2
1918	296,520,000	9,689,000	3.3	1937	902,307,000	190,679,000	21.1
1919	691,519,000	13,332,000	1.9	1938 [1]	1,100,000,000	130,000,000	11.8

[1] Preliminary.

Source: Commercial and Financial Chronicle, State and city section (prior to 1925), and State and Municipal Compendium (1925 to date).

EXHIBIT B.—*Numbers and amounts of callable municipal issues by years, 1920–36*

Years	Numbers [1]			Amounts [2]		
	Callable issues [3]	Total issues [4]	Percentage of total issues	Callable issues [5]	Total issues [6]	Percentage of total issues
1920	487	4,947	9.84	$32,655,370	$595,580,900	5.48
1921	618	6,720	9.19	44,692,190	917,875,400	4.86
1922	696	9,029	7.78	51,288,690	954,758,000	5.37
1923	365	7,575	4.81	22,194,630	830,394,733	2.67
1924	373	7,201	5.17	24,846,060	1,149,436,400	2.16
1925	408	7,836	5.20	89,482,150	1,237,718,600	7.22
1926	331	7,078	4.67	78,157,160	1,234,483,500	6.33
1927	259	7,748	3.35	44,474,200	1,378,293,800	3.22
1928	335	7,233	4.63	77,415,950	1,252,292,500	6.18
1929	226	6,184	3.67	58,623,500	1,270,906,900	4.61
1930	284	5,914	4.82	75,570,690	1,250,025,200	6.04
1931	240	4,480	5.35	52,746,950	1,008,623,400	5.22
1932	125	3,093	4.04	15,982,250	653,273,400	2.44
1933	64	2,516	2.54	13,855,900	327,793,500	4.22
1934	127	4,630	2.74	35,944,980	663,030,933	5.42
1935	187	4,378	4.27	65,065,930	907,785,597	7.16
1936	186	5,318	3.49	79,362,900	914,562,646	8.67
Total	5,311	101,880	5.21	862,359,500	16,546,835,409	5.21

[1] State and municipal issues.
[2] Municipal issues only.
[3] Source: Municipal Bond Sales, annual volume.
[4] Source: The Bond Buyer.
[5] Source: Municipal Bond Sales, annual volume.
[6] Source: Commercial and Financial Chronicle.

Source: Municipal Finance Officers' Association, The Call Feature in Municipal Bonds, p. 113.

EXHIBIT C.—*Total number of defaults*

Classes of units	As of Jan. 1—			
	1935	1936	1937	1938
Regular units:				
Counties	349	309	258	186
Cities and towns	851	816	735	753
School districts	623	840	806	738
Total	1,823	1,965	1,799	1,677
Special units:				
Irrigation, reclamation, and drainage districts	[1] 662	689	803	862
Special assessments		233	211	302
Other districts	209	272	238	245
Total	[2] 871	1,194	1,252	1,409
Aggregate total	[2] 2,694	3,159	3,051	3,086

[1] Inclusive of special assessment defaults as of Nov. 1, 1934.
[2] Exclusive of some special units.

Source: The Bond Buyer.

EXHIBIT D.—*Average coupon rates on State and local bond issues, 1901–37*

Year	Average coupon rate		Year	Average coupon rate	
	Yearly	5-year		Yearly	5-year
1901-05		3.8	1928	4.4	
1906-10		4.3	1929	4.7	
1911-15		4.5	1930	4.4	
1916-20		4.8	1926-30		4.6
1921	5.4		1931	4.2	
1922	4.9		1932	5.0	
1923	4.8		1933	4.6	
1924	4.7		1934	3.9	
1925	4.6		1935	3.3	
1921-25		4.8	1931-35		4.1
1926	4.7		1936	3.1	
1927	4.5		1937	3.3	

Compiled from U. S. Department of Commerce, Long-term Debts in the United States, 1937, p. 175, and Commercial and Financial Chronicle, State and Municipal Compendium.

STATEMENT OF HENRY C. MURPHY, PRINCIPAL ECONOMIC ANALYST, DIVISION OF RESEARCH AND STATISTICS, TREASURY DEPARTMENT

Mr. MURPHY. Mr. Chairman and gentlemen of the committee: Mr. Hanes has asked me to discuss the probable changes which would occur in the cost of borrowing to the Federal Government and to State and local governments if future issues of public securities were made subject to income taxation by both the Federal and by State and local governments.

The changes which we are interested in here are, of course, those in the rates for new borrowing, since it is only hereafter issued securities which would be affected by the proposal under consideration, and, in any event, the interest cost to a borrower is not affected by fluctuations in the prices of its securities subsequent to their original issuance. Most of my discussion, however, will necessarily be based upon the yields of securities now outstanding, as much of our general reasoning may be expressed more conveniently in terms of such securities, and as it is only with respect to already outstanding securities that we have more than very occasional quotations upon which to base inferences. There is no difficulty in this procedure, however, as the rate at which any borrower may issue new obligations is, in general, best inferred from the yield on its obligations already outstanding.

There are two general avenues of approach to the question of the amount of the yield differential, if any, which public securities now enjoy because of the various types of tax exemption which they possess. First, we may reason about this differential, and second, we may look at it as it actually exists in the market place or perhaps the cornfield.

Each of these approaches is necessary to get a complete picture and I propose to use them both, but first I should like to anticipate a question which probably comes into your minds—that is, why we should reason about the differential at all if we can actually measure it in the market place. The answer is that the proper method of measuring it is exceedingly complex and subject to a wide margin of error, and comparisons made without a proper background are more confusing than helpful. I should like to illustrate this by a concrete example taken from the testimony offered by one of the opposition witnesses.

Mr. W. E. Kershner, secretary of the Ohio State Teachers' Retirement System, testifying against the proposal before this committee, purported to demonstrate by facts and figures that certain Ohio bonds, the income on which is subject to a 5 percent tax, sell at a yield differential of over three times the amount of the tax saving as compared with tax-free bonds. He concluded this part of his testimony with the somewhat ironical statement that "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." The point of this conclusion, as it applies to the proposal under consideration by your committee, is pretty obvious, but let us look into the method by which it was obtained.

Mr. Kershner says, "In the examples I shall give there is no guesswork. These are actual quotations, and all during the last 3 months of 1938." One of his comparisons is as follows: "Cincinnati tax-free 3¼-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."

What are the facts about this comparison? In the first place, the quotations do not purport to be as of the same date. They may be as much as 3 months apart and the Bond Buyer's index of the yields of the bonds of 11 first-grade cities changed by a net amount of twenty-one one-hundredths of 1 percent between October 1, 1938, and January 1, 1939.

Much more important, the tax-free 3¼'s are callable, perhaps as early as 1942 and certainly as early as 1946, depending upon which of several possible issues Mr. Kershner may have had in mind. The taxable 5's, on the other hand, are not callable prior to their final maturity in 1965. The prices corresponding to the yields quoted by Mr. Kershner are from about 107 to about 113 for the tax-free 3¼'s, depending upon earliest call date, and about 152 for the taxable 5's.

If, by chance, the tax-free bonds should not be called and should run to their final maturity in 1965 they would give the relatively high yield of from about 2.85 percent to about 3.10 percent, or at least fifty one-hundredths of 1 percent more than that on the taxable bonds. The yield on the taxable 5's, on the other hand, is prevented from declining further than it has by the somewhat astronomic premium of about 52 points.

The answer is, of course, that the example proves absolutely nothing about the yield differential between different issues of Ohio bonds due to the taxation of some of them but not of others by a State income tax, or about anything else. Mr. Kershner's other examples are subject to like criticism—which, if the committee wishes, I should be glad to place in the record—but on the basis of them, he concludes that "it is conservative to say that the spread is 0.75 percent."

I believe that it should be noted here in passing that Mr. Kershner appeared against the interests of his constituents rather than for them, as it is certainly the interest of the teachers who are members of the Ohio State Teachers' Retirement System that they should receive the full standard rate of interest on the funds invested on their behalf rather than a rate artificially depressed by exemption from a tax to which the fund would not be subject in any event.

Professor Lutz refers to Mr. Kershner's results in his report, and Mr. Tremaine devotes a little over a page of his seven-page statement to this alleged Ohio differential, stating that it sometimes is as high as five times the amount of the tax. Mr. Tremaine gives no examples, but it seems a not unreasonable inference, in view of the integrated character of the testimony of the opposition, that his conclusions are based upon Mr. Kershner's examples or others like them.

Would the committee like to have the other examples?

The CHAIRMAN. They will be received and copied in the record.

(The examples referred to by Mr. Murphy will be found at the conclusion of his statement.)

Mr. MURPHY. Since this testimony was given, I have talked to a bond dealer in Cleveland thoroughly conversant with the Ohio municipal market, who estimated that there is no differential at all between the yield of the taxable and tax-free bonds under consideration for maturities under 5 years and that for maturities over 10 years the differential amounts to about twenty-five one-hundredths of 1 percent.

This is about what we should expect from reasoning about the matter, and here, as in many other cases, a careful consideration of what might reasonably be expected to happen gives a result more accurate in fact than what purports to be a spot comparison. This leads us back to the subject of the general principles underlying the determination of the differential, if any, in market yield, between taxable and tax-free bonds, a subject which I believe that we may now approach more patiently, while the pitfalls of the method of random comparison are so clearly before our eyes.

I believe that at the point the statement should be inserted in the record that the Treasury does not deny that differentials exist with respect to most of these bonds, but does certify that with respect to a large amount of very short-term securities there is in fact no differential.

The broad outlines of the method by which the market sets, or sometimes fails to set, a differential between the yields of taxable and tax-free bonds may be stated fairly simply. In all of my discussion I shall ignore the problem of intergovernmental relationships and shall assume that all levels of government are interested in the common welfare of all on a consolidated balance sheet basis.

Senator AUSTIN. Excuse me just a moment. I would like to ask, will you admit there are different levels of interest in this matter, that is as between the Federal, State, and municipal governments; when you assume in your discussion to ignore the problem of intergovernmental relationships, aren't you getting out of joint with the factual conditions?

Mr. MURPHY. No; I am merely calling your attention to the facts. I am merely discussing all the contingencies of the case, for, I am a technician. I know that there are different levels involved and different governments stand to lose considerably more than they gain by this proposal, and would be the last one to deny it. The only thing I can impress in the particular discussion is that I am abstracting from that. As to the other aspects of the problem, we have another witness who will discuss the intergovernmental relationships.

Senator AUSTIN. You are assuming the Federal income?

Mr. MURPHY. Yes, sir.

Senator AUSTIN. And you are taking the initial situation?

Mr. MURPHY. I am endeavoring to give an anlysis——

Senator AUSTIN. I do not think you understand my question. I am not talking about your interest. I have no doubt you deal with the matter scientifically. I am sure you do that. But, are you not basing your claim on Federal bonds, Federal securities, rather than taking a composite of all these different issues?

Mr. MURPHY. No, sir; what we are endeavoring to do is to take a composite. It is our contention that if we consolidated the accounts of all of the different levels of government, there would be a substantial gain from a fiscal standpoint, that is, revenue would be substantially increased. It does not follow that each of those levels would gain in revenue.

Senator AUSTIN. Very well, I understand what you are doing. It was not clear to me.

Mr. MURPHY. What we are doing is endeavoring to look at the problem as a whole. We know that various levels will be able to adjust their differences, and if all of these levels as a whole stand to gain, the thing to do is to go ahead with the proposition and distribute the net benefits between the various levels of government in whatever way the policy forming officers may see fit. I am only discussing it on the basis of the technical level.

If all income, except that from tax-free bonds, were subject to taxation and to taxation at the same rate, and if the expectation of the market was that the tax would continue at the same rate, or in any event was as likely to move one way as the other, then the yield on tax-exempt bonds would be less than that upon taxable bonds by the amount of the tax saving. Under such circumstances, the issuance of tax-exempt bonds might perhaps be a good thing, since by the use of them the Government could, in effect, collect its taxes at the source with less expense of collection and less loss of revenue than it would incur by paying the money out and then taxing it back again.

I use the word "perhaps" advisedly in saying that the issuance of tax-exempt bonds might be a good thing under such circumstances. The differential in yield between taxable and tax-free bonds which would exist under such conditions would, of course, reflect the expectation of the market with respect to future tax rates rather than the tax rate actually existing. If it were the preponderant expectation of the market either that taxes were going to go up or that they were going to go down, the actual differential might be more or less than enough to offset exactly the existing tax. By the issuance of tax-exempt bonds, however, even under such otherwise ideal conditions, the Government would tie its hands with respect to future changes in the tax rate on that portion of the income of the economy represented by interest on tax-exempt securities.

If taxes went up, the holders of tax-free bonds would continue to be charged in effect a tax of merely the guessed-at future rate at the time their bonds were issued; while if taxes went down, they would have to continue to bear this rate, even though it might be considerably more than that paid by other segments of income. The Government, in other words, by issuing tax-exempt bonds, even under such conditions would impair its flexibility with respect to future tax policy and this impairment might be considered of more importance than the revenue collection costs which it avoided.

The conditions which I have just outlined are the most favorable possible for the issuance of tax-exempt securities. The tax-exempt Ohio bonds to which I have already referred seem to approximate these conditions. There are very few of these bonds outstanding—only the residue of bonds issued prior to 1913 and not yet retired. The whole outstanding amount of these bonds appears to be less than the demand for them on the part of the people subject to the Ohio level—that is, nongraduated—5-percent tax on income from intangible property. The amount of yield differential necessary to offset this tax on a bond with a 4-percent coupon—the tax is levied on the coupon and not on the yield—is twenty one-hundredths of 1 percent and there appears to be a preponderant expectation that the tax is more likely to be raised than lowered. The actual market differential of about twenty-five one-hundredths of 1 percent which I have cited with respect to long-term tax-free Ohio municipals as compared with corresponding taxable issues is therefore in line with logical expectation and so reinforces the credence which we would feel justified in giving to a purported market observation of about this amount.

The general conditions of the issuance of tax-exempt securities in the United States today are quite different. The Federal income tax, which is the most important tax from which the interest on these securities is exempt, is levied at rates varying all the way from 4 to 79 percent for individuals, and from 12½ to 19 percent for corporations. If so few bonds were outstanding that they could all be absorbed by persons in the highest tax bracket, there would be a differential in yield between taxable and tax-free bonds corresponding to the tax in this bracket, and the Government would suffer no loss, as in the preceding example. In practice, however, the amount of tax-exempt bonds now outstanding is so large that tax-exempt securities are held by investors in all tax brackets and by many paying no tax at all.

What should we logically expect to happen under such circumstances? As Professor Lutz does not seem to be pleased by the perfectly orthodox analysis of this point, which I made in a recent paper, I think it might be better for me here to quote an analysis of exactly the same purport, but in stronger language, made by Professor Haig, of Columbia University, in an article written 15 years ago in the North American Review, April 1923. The rates of tax which he quotes are those of the Revenue Act of 1921 but fortunately the principles of good reasoning do not change much with the years.

So long as tax-exempt bonds are restricted to an amount which can be readily absorbed by the heaviest taxpayers—those in the highest surtax group—the Government can expect to receive a full return for the exemption granted, for the market value of the bonds (or, what amounts to the same thing, the rate of interest) will be established by the demand of those to whom the exemption is most precious. Just so soon, however, as the number of such bonds exceeds the demands of this group of very rich men and it becomes necessary to dispose of them to taxpayers in the next lower class, the market value of the bond begins to drop. For such a bond cannot be sold to a $150,000 man who saves only $19.95 by purchasing it, at as high a price as can profitably be paid by a $200,000 man who saves $20.30. The lower market-standing of the bond, now fixed on the basis of its value to the $150,000 man, is a value which extends to the entire issue, so that the $200,000 man may now buy his bond at a price lower than its full worth to him. In other words, through this process by which the market value of the bond declines, the $200,000 man reduces his true, effective tax rate to the level of the $150,000 man. The law says that he shall pay a 58 percent income tax on his income in excess of $200,000. By buying a tax-exempt bond at a price fixed by the value of the exemption to the man in the $150,000 class, he reduces that 58 percent to 57 percent. The tax-exempt bond is then a device which has the peculiar quality ascribed to the Scotch hen of the old nursery rhyme.

Bobby Shaftoe has a hen,
Cockle button, cockly ben,
She lays eggs for gentlemen,
But none for Bobby Shaftoe!"

If Congress was really in earnest when it said that equality of tax burdens demanded 58 percent of every dollar of income received by an individual above $200,000, then, in authorizing the issuance of tax-exempt bonds in such numbers that their market price is determined by relatively small taxpayers, it has destroyed that equality. Consciously or unconsciously, by its own act it has created a device whereby that dollar is actually burdened less than the 58 percent which justice and equality presumably demand.

Professor Haig's reasoning is perfectly clear and is the standard reasoning on this subject. Its only difficulty is that it seems to prove too much, for in view of the large amount of tax-exempt securities now outstanding and outstanding at the time that Professor Haig wrote, and in view of the large amount of such securities held at both dates by investors not subject to income tax, it is hard to explain why there should be any differential at all between the yields of taxable and tax-free securities. Yet direct observation shows that there is some differential now, and was some at the time when Professor Haig wrote.

The only new contribution to the subject that my paper, which Professor Lutz has criticized so severely, purported to make was an explanation of why we should logically expect to find some differential in the market between the yields of taxable and tax-exempt securities, despite the standard reasoning along the lines which I have quoted from Professor Haig, for it is the existence of a differential at all under present conditions which logically requires explanation and not its small amount. This point, of course, Professor Lutz completely missed.

I do not believe that I need go at any length into the explanation of this point because it is very technical and because the existence of a differential is conceded by the opposition witnesses, although I should be glad to give a full explanation of it if the committee desires. The essence of the point is that public securities, quite irrespective of their tax-exemption privileges, are the only type of securities which satisfy the demands of many classes of investors. These investors must buy them, whether or not, and pay the going rate. Their demand is not sufficient to absorb the whole quantity, however, and a portion of the outstanding supply must be sold to other classes of investors who are not particularly enthusiastic purchasers of the securities as such but desire the tax-exemption privilege, and it is the demand of these investors which sets the differential which actually exists in the market. The demand of the first class of investors—the demand which is irrespective of the tax-exemption privilege—is greater than the whole outstanding supply of short-term public securities so that the differential only appears in practice in the market on the longer-term securities.

So much for the approach to the problem of the differential through reasoning about it. I shall now turn my attention to actual yield comparisons.

There are two general types of such comparison possible. First, we may compare the yield differentials now existing between taxable and tax-free securities with those existing at earlier dates before the taxes to which the taxable securities are now subject were levied, or when they were levied at lower rates. Second, we may compare the present yields of taxable and tax-free securities as nearly alike in all other respects as may be possible.

I shall take up first the historical type of comparison. It happens that while it doesn't tell us much about the differentials which actually exist in the market today because of the tax-exemption privilege, it does shed worlds of light upon a number of things which are not so, but which are alleged to be.

Professor Lutz says on page 107 of his report on the Fiscal and Economic Aspects of the Taxation of Public Securities:

* * * 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 (which is here inserted in Professor Lutz's text).

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.

Professor Lutz's observations would be very significant if the figures upon which they are based were correct. Unfortunately, they are not.

TABLE I.—*Comparison of the differential in yield between high-grade corporate and municipal bonds and the maximum rate of the Federal individual income tax, 1900–38*

[Percent—annual averages for yields]

Year	High-grade corporate bonds [1]	Municipal bonds [2]	Differential	Maximum Federal individual income tax
1900	4.05	3.12	0.93	----------
1901	3.90	3.13	.77	----------
1902	3.86	3.20	.66	----------
1903	4.07	3.38	.69	----------
1904	4.03	3.45	.58	----------
1905	3.89	3.40	.49	----------
1906	3.99	3.57	.42	----------
1907	4.27	3.86	.41	----------
1908	4.22	3.93	.29	----------
1909	4.06	3.78	.28	----------
1910	4.16	3.97	.19	----------
1911	4.17	3.98	.19	----------
1912	4.21	4.02	.19	----------
1913	4.42	4.22	.20	7
1914	4.46	4.12	.34	7
1915	4.64	4.16	.48	7
1916	4.49	3.94	.55	15
1917	4.79	4.20	.59	67
1918	5.20	4.50	.70	77
1919	5.29	4.46	.83	73
1920	5.79	4.98	.81	73
1921	5.57	5.09	.48	73
1922	4.85	4.23	.62	58
1923	4.98	4.25	.73	58
1924	4.78	4.20	.58	46
1925	4.67	4.09	.58	25
1926	4.51	4.08	.43	25
1927	4.31	3.98	.33	25
1928	4.34	4.05	.29	25
1929	4.60	4.27	.33	24
1930	[3] 4.55	4.07	[3] .48	25
1931	4.58	4.01	.57	25
1932	5.01	4.65	.36	63
1933	4.49	4.71	−.22	63
1934	4.00	4.03	−.03	63
1935	3.60	3.41	.19	63
1936	3.24	3.07	.17	79
1937	3.26	3.10	.16	79
1938	3.19	2.91	.28	79

[1] Yields from 1900 through 1929 are those reported by Standard Statistics Co. for 15 high-grade railroad bonds. Yields from 1930 through 1938 are those reported by Moody's Investors Service for high-grade corporate (Aaa) bonds.

[2] Yields are as reported by Standard Statistics Co.

[3] Standard Statistics Co. index of yields of high-grade railroad bonds was 4.39 percent for 1930, and the differential based upon this index, 0.32 percent.

SOURCE: Treasury Department, Division of Research and Statistics.

Table I compares the yield differential for corporate and municipal bonds from 1900 to the present time with the maximum rates of the Federal income tax during the years since this tax has been levied.

The municipal-bond index used during the entire period is that of the Standard Statistics Co. The corporation bond series used for the period 1900–29, inclusive, is the Standard Statistics Co.'s index of the yields of 15 high-grade railroad bonds, and from 1930 to date Moody's average of Aaa corporation bonds. The change is necessary because of the difficulties in railroad credit in recent years to which Professor Lutz referred in the passage which I have just quoted, and does not materially affect the comparability of the series over the period. The use of any of the regularly published indexes would give results similar in kind to those shown in the appended table; that is table I.

What does the table show? Perhaps the most striking thing it shows is that the greatest differential in favor of municipal bond yields as against corporation bond yields occurred in 1900, long before the Federal income tax appeared to be a reasonable probability. In 1933, however, when the Federal individual income tax was being levied at a maximum rate of 63 percent and was considered more likely to advance further than to decline, municipal bonds were actually yielding more than corporation bonds. The actual figures are: An excess of ninety-three one hundredths of 1 percent of corporation bond yields over municipal bond yields in 1900, and an excess of twenty-two one hundredths of 1 percent of municipal bond yields over corporate bond yields in 1933—a net movement of 1.15 percent against the municipal bonds during the period when the tax situation changed from the remote possibility that there might be a Federal income tax some day, if the Constitution should ever be amended to permit it, to a time when such a tax was being levied at rates running as high as 63 percent.

This is exactly the opposite of what Professor Lutz says. Let me quote him again:

> * * * 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 * * * The yield spread or differential between public and private securities has been more persistent, however, since the development of progressive taxation. * * *

These two conclusions, both purporting to be based upon facts, appear to differ widely. What is the reason? Professor Lutz cites figures only for the years 1902, 1912, and 1922. Let us examine the figures for 1902.

Professor Lutz cites the Bond Buyer's Index of the yields of 20 municipals for that year as 3.18 percent, while the Standard Statistics Co.'s index, cited in table I, is 3.20 percent, a difference of only two one-hundredths of 1 percent. The difficulty, therefore, cannot be on the municipal side of the comparison, so it will be necessary to look into the corporate side.

The Standard Statistics Co.'s index of the yields of 15 high-grade railroad bonds cited in table I is 3.86 percent. Professor Lutz cites two figures, one for "all railroad bonds" and one for "first-grade railroad bonds." He does not cite the source of the figures other than to say that the data are supplied by the Bond Buyer, the leading trade journal in the municipal bond field.

The figure for all railroad bonds cited by Professor Lutz is 3.75 percent, or eleven one-hundredths of 1 percent less than the yield on the Standard Statistics Co.'s index of high-grade railroad bonds. A low yield, you will remember, indicates high quality, and if we are to accept Professor Lutz's figures, we are asked to believe that the Standard Statistics Co.'s index of high-grade railroad bonds was so ill-selected that the bonds included in it turned out to be of considerably less than average quality, and so yielded eleven one-hundredths of 1 percent more than the average of all railroad bonds.

Even if we should use the average of 3.75 percent for "all" railroad bonds, however, as our index of corporation bond yields in 1902, the point which I have just made would stand, and Professor Lutz's point would fall, since there would still be a differential of about sixty one-hundredths of 1 percent in favor of the municipal bonds, over 10 years before the income tax. In order to make Professor Lutz's point, it is necessary to use the figure of 3.25 percent which he cites for "first-grade" railroad bonds. This yield, however, is less than that on all but one of the 15 bonds included in the Standard Statistics Co.'s index for that year, the yield of that one bond being 3.24 percent. I leave it to your judgment which set of data you are prepared to accept.

Senator AUSTIN. Excuse me just a moment, have you stated in in your testimony anywhere the comparable figure given by the Standard Statistics Co., that is the percent of all railroad bonds for the year 1902?

Mr. MURPHY. I know of no such figure.

Senator AUSTIN. Then you are not making a true comparison?

Mr. MURPHY. Yes; I say this: Standard Statistics has picked out 15 railroad bonds which are the pick of the flock. Professor Lutz cites a figure which purports to be the yield of all railroad bonds, but does not give the source. I know of no published figures on the yields of all railroad bonds.

Senator AUSTIN. Therefore, you are making a comparison on all railroad bonds as compared with the Standard Statistics reports on 15 railroads?

Mr. MURPHY. Yes, sir.

Senator AUSTIN. So long as we know what theory you have in mind, then we know what weight to give the comparisons, and then we will give such weight as we see fit.

Mr. MURPHY. I was just saying that if we should accept this 3.75 percent yield for all railroad bonds, Professor Lutz's point would fall, since there was a differential of about sixty one-hundredths of 1 percent in favor of municipal bonds in 1902, long before the income tax had been thought of. You will remember the figure for municipal bonds was 3.18 percent.

This concludes what I have to say concerning the historical method of determining the amount of the differential between corporate and municipal bond yields properly attributable to tax exemption. The results are completely negative as far as telling us anything about the magnitude of the present differential, if any, but they illustrate vividly the pitfalls of some of the comparisons which were presented to your committee last week.

I now turn to the other method of determining the differential—that of comparisons between different classes of securities in the present and recent markets. I should like first, however, to comment again upon Professor Lutz's methodology in determining the yield differential between State and local, and corporate securities due to the Federal income tax.

After his historical comparison, Professor Lutz proceeds to evaluate the present differential upon the basis of three methods of approach.

First, he sent a list of 27 specific State and municipal bond issues to 13 dealers and 4 insurance companies, and asked their opinions as to how much the yields on these issues would rise if they were subjected to the Federal income tax. Averaging the opinions of the 13 dealers on the 27 issues, he obtained an estimated differential of sixty-one one-hundredths of 1 percent and averaging the opinions of the 4 insurance companies, an estimated differential of sixty-eight one-hundredths of 1 percent. It is hard to evaluate these estimates directly as they are based purely upon opinion and not statistics, and we naturally have no idea of the amount of consideration given by the dealers and insurance companies to Professor Lutz's questionnaire. It is interesting to note, however, that the opinions of the dealers with respect to the average of all the issues ranged from an estimated differential of thirty one-hundredths of 1 percent to an estimated differential of 1 percent, while their opinions with respect to a single issue—State of Pennsylvania 5's, due in 1951—varied fron twenty one-hundredths of 1 percent to 1.25 percent; that is, the high estimate was over six times the low one.

Professor Lutz says with respect to this evidence:

> While these figures constitute opinion evidence only, they deserve consideration in view of the source from which they come * * *. Another and more objective test is supplied by the bond market itself.

In pursuance of this more objective test, he presents a series of tables included in his report as appendixes B and C. He infers that these tables, and charts I and II in the text which are based upon them, prove his point that the actual differential is about sixty one-hundredths of 1 percent, although he never discusses what they really do show.

The tables show the yields of Treasury, municipal, and corporation bonds but do not show the differentials between taxable and nontaxable bonds—the subject under discussion. These differentials are easily obtainable, however, by subtraction. When this is done, it appears that the tables show that the gross differential fluctuates widely in amount and occasionally runs in favor of the corporate bonds rather than of the municipals.

In short, the figures which Professor Lutz presents in connection with his second method of approach—the actual comparison of bond yields in the present market—simply do not prove his point. There is a complete lack of connection, in fact, between the figures and the point which they are supposed to prove. I do not want to take up the time of the committee unnecessarily on this matter, and I should appreciate it if I may present for the record at this point a memorandum discussing more fully Professor Lutz's method of determining the differential, both for State and local and for Federal securities and with respect to both State and local and Federal taxation. This memorandum includes Professor Lutz's own tables with differential columns added.

Senator AUSTIN. May I ask if you have taken Professor Lutz's theory and reformed the calculations he has made?

Mr. MURPHY. His method consists of three steps——

Senator AUSTIN. No; I am talking about his method; isn't that the theory to put in the record at this point? This last statement you have made is a mere claim. There is not any basis of judgment that I can find in it and, if you are coming up to this committee and asking for judgment as between your claim and Professor Lutz's claim, we would like to have it in full in here, for we do not want to be misled.

Mr. MURPHY. These points are covered in the memorandum which I should like to submit. Professor Lutz has three methods of approach. The first approach consists of opinions collected from persons presumably in a position to give them. I have made no comment as to those opinions other than to point out that they vary widely and, in order to apply the same method, we also would have to send out a questionnaire. Frankly, it does not seem a reasonable method to us because we are not sure that we would get the unbiased opinions of those to whom questionnaires might be sent. We call your attention to the fact that Professor Lutz suggests taking the opinions for what they are worth, and we are quite willing to do so.

In Professor Lutz's second method of analysis, he presents tables showing the yields of high-grade corporation and high-grade municipal bonds and yet, he does not show the differential between those two yields.

We have taken Professor Lutz's tables, have added the yield differentials, and are presenting the resultant tables for the record.

Senator AUSTIN. Do you mean to make a comparison of Treasury bonds, municipal bonds, and State bonds?

Mr. MURPHY. Yes, sir. Our method of treatment of the differential, with respect to which I will later introduce a memorandum, is the same as Professor Lutz's method except that we have shown the whole thing so that you might have an opportunity of seeing the complete picture and might take your choice as to which is correct.

The CHAIRMAN. That is good.

Mr. MURPHY. May we now offer this memorandum?

The CHAIRMAN. It will be received.

(The said memorandum appears at the conclusion of Mr. Murphy's remarks.)

Mr. MURPHY (continuing). Professor Lutz's third method of approach to the amount of the differential is to take the average rate of tax which he estimates would be paid by all holders of State and local securities, were they taxable, and assume that the yield on these securities would be increased by the amount of this average tax. I say he assumes that the yield would be increased by the average amount of the tax because he makes no effort to prove it. This assumption is quite unjustified, however, since an average tax is no man's tax. The differential is determined by the marginal tax, that is, the tax upon the person who has found it just worth while to purchase the bonds, considering the differential in yield below the standard rate on the one hand, and his own tax on the other. This tax is much less than the average tax. I need not go into this point, however, because it is in no way connected with the direct observation of market yields with which we are here concerned and because it is already so well demonstrated in the quotation from Professor Haig which I stated earlier.

To summarize Professor Lutz's method of determining the differential: He first introduces certain opinions which average out at about sixty one-hundredths of 1 percent despite wide variations between the individual opinions. Secondly, he introduces, but fails to discuss, certain tables which, however, do not establish the conclusion which he desires to reach. Finally, he makes an assumption with respect to the effect of a progressive income tax upon tax-exempt bond yields, which he does not support, and which is not supportable by reasoning. He then concludes that the differential is approximately the amount which the average of the opinions which he first introduced indicated. The second and third of his methods of analysis add absolutely nothing to the first, so that his final conclusion is based entirely upon opinion, and opinion alone. It is upon this statistical basis, as far as alleged interest losses due to Federal taxation of State and local securities are concerned, that Professor Lutz's elaborate structure of conclusions is erected.

I now turn to our own estimate of the amount of the yield differential between taxable and tax-exempt securities due to the tax-exemption privilege. In order to avoid taking up any more of the committee's time than necessary, I should like to submit for the record at this point a brief memorandum on the method by which we estimated this differential and say only a few words about it here.

I submit this memorandum.

The CHAIRMAN. It will be received and copied in the record.

(The said memorandum will be found at the conclusion of Mr. Murphy's statement.)

Mr. MURPHY. Briefly, an average of the best grade of municipal securities—the Bond Buyer's average of the bonds of 11 first-grade cities—at the first of the year was selling to yield a little less than one-fourth of 1 percent less than the longest maturity of partially tax-exempt Treasury bonds. This sets the bottom of the range which we have allowed for the present market valuation of the tax-exemption privilege.

High-grade corporation bonds, on the other hand, at the same time were selling to yield about an even one-half of 1 percent more than the municipals, and assuming, as appears to be the case, that the municipals are, if anything, superior in quality, one-half of 1 percent may be taken as the top limit of the range of the market's estimate of the value of the complete tax-exemption privilege on long-term high-grade securities.

This is where the one-fourth to one-half of 1 percent comes from. As we compare securities with shorter maturities, the differential dwindles away and amounts to little or nothing for securities with maturities of 3 years or under.

The estimate of the market's valuation of the partial tax-exemption privilege is based upon a comparison of the yields of partially tax-exempt Treasury bonds and high-grade corporate bonds. The Treasury bonds were selling to yield only twenty-eight one-hundredths of 1 percent less than the corporate bonds, and are superior to them in a great many ways, so that it does not seem reasonable to assign more than five one-hundredths to fifteen one-hundredths of 1 percent as the market valuation of the partial tax-exemption privilege. If we should take the top figure of this range—that is, fifteen one-hundredths of 1 percent—the remaining amount of yield differential left to explain all the points of superiority of Treasury bonds over corporate bonds would have been only thirteen one-hundredths of 1 percent as of January first.

If we should take Professor Lutz's estimate of the value of this differential as one-half of 1 percent, we should have to suppose that the Treasury bonds are not really as good and as safe securities as the corporate bonds, but sell at somewhat lower yields because their partial tax-exemption privilege more than makes up for their poor quality.

Professor Lutz has stated in appendix H of his report that there is a discrepancy between the remarks in Mr. Hanes' statement on the amount of the interest differential and the estimate there presented of increased interest cost to the Federal Government should the tax-exemption privilege be eliminated.

This is not the case. Mr. Hanes in his statement naturally did not go into the details of estimates for various classes of securities, but stated simply that—

> * * * the differential between the yields of completely taxable and wholly tax-exempt high-grade securities varies from zero, or practically zero, for the shortest maturities up to about one-fourth to one-half of 1 percent for the longest. The yield differential in favor of long-term partially tax-exempt securities, that is, those that are exempt only from normal income tax, as compared with completely taxable securities of equal quality, is estimated at from five one-hundredths to fifteen one-hundredths of 1 percent.

TABLE II.—*Estimated ultimate annual increase in interest costs which would result from removal of the tax-exemption privilege from public securities, assuming the ultimate replacement of tax-exempt public securities outstanding on June 30, 1937, by taxable securities*

Securities	Principal amount (millions of dollars)	Low estimate		High estimate	
		Rate on principal amount (percent)	Interest cost (millions of dollars)	Rate on principal amount (percent)	Interest cost (millions of dollars)
State and local securities (including Territories and insular possessions)	[1] 16,113	0.25	40.3	[2] 0.65	104.7
United States pre war bonds (except postal savings bonds) and wholly exempt securities of Federal instrumentalities	[3] 1,546	.25	3.9	.50	7.7
Postal savings, United States savings, and adjusted service bonds and special issues	2,865	None	None	None	None
United States wholly exempt securities except pre-war, postal savings, and adjusted-service bonds and special issues	12,920	.02	2.6	.04	5.2
United States partially exempt securities except United States savings bonds	19,936	.05	10.0	.15	29.9
Partially exempt securities of Federal instrumentalities	[4] 4,689	.05	2.3	.15	7.0
Total	58,069	.10	59.1	.27	154.5

[1] Exclusive of securities held in sinking funds and by the United States, and of one-half of securities held in public trust and investment funds.
[2] Equivalent to 20 percent of the interest disbursement adjusted to 1937 borrowing rates.
[3] Exclusive of Federal Land Bank bonds held by the Federal Farm Mortgage Corporation.
[4] Exclusive of Reconstruction Finance Corporation notes and Home Owners' Loan Corporation bonds held by the Treasury.

Treasury Department, Division of Research and Statistics.

Table II gives a detailed break-down of the manner in which the estimate of increased interest cost presented in Mr. Hanes' statement was obtained. I should like especially to direct the attention of the committee to the extra differential which is allowed in the maximum figures of this estimate for any increase in borrowing cost over one-half of 1 percent which may be incurred by communities with a relatively poor credit standing.

In the case of State and local securities, we have assumed a rate of twenty-five one-hundredths of 1 percent in arriving at the low estimate of interest cost and of sixty-five one-hundredths of 1 percent—five one-hundredths of 1 percent higher than Professor Lutz's figure—in arriving at the high estimate. These rates are based upon the differential due to tax-exemption which we have estimated at one-fourth to one-half of 1 percent on high-grade securities. For the low estimate, we have used the one-fourth of 1 percent rate. For the high estimate, we have used the one-half of 1 percent rate, which is equivalent to 20 percent of the average yield of about 2½ percent on high-grade municipal securities. Applying this 20 percent to the average cost of about 3.25 percent on new long-term municipal borrowings, produces a differential on new borrowing of sixty-five one-hundredths of 1 percent, which we use in arriving at the high estimate. The effect of this procedure is to use the maximum estimate of the differential due to tax-exemption on high-grade municipal securities, and apply it on a proportional basis to all municipal securities, including those of lower quality.

Senator AUSTIN. Let me ask, if we make an additional column on Mr. Lutz's table which begins on table 191 of his report, if we make an additional column there which represents the differential by which the corporation index exceeds the municipal index, then will we reproduce your table, or have one analogous to it?

Mr. MURPHY. There are several difficulties. In the first place, you get several different differentials by reference to Professor Lutz's tables. The differences arise mainly because of variations in the quality of the bonds compared. We have derived our estimate of the maximum differential, on the other hand, by comparing the Bond Buyer's index of the bonds of 11 first-grade cities and the Treasury's index of the yield of 15 high-grade corporation bonds, not including rails. The method is essentially that of Professor Lutz's reasoning. Perhaps I make my statement unnecessarily complex.

Senator AUSTIN. No, you do not. You are making an explanation that is essential.

Mr. MURPHY. In one of Professor Lutz's tables, he has four series of corporation bond yields—industrial A1+ bonds, railroad A1+ bonds, public utility A1+ bonds, and the average of all A1+ corporation bonds. These series are compared with the average of 15 first-grade municipal bonds. The differentials between the corporate bonds and municipal bonds vary widely, depending on which of the four series of corporation bonds you use. The only way you can get the differential due to tax-exemption is to compare bonds that are strictly high-grade on both sides of the fence. Therefore, the column which we put on Professor Lutz's table states the differential between public utility bonds and his municipal bond column.

Now, our figures which are given in the third of the exhibits we have in the record are based upon the same method. That is we have the best grade of corporation bonds we can get maturing past 1960. That puts them out at the end of the curve showing the relationship between the maturities and yields. We compare this index of high-grade corporate bonds with the Bond Buyer's index of the bonds of 11 first-grade cities and derive a differential in favor of the municipals of fifty-one one-hundredths of 1 percent as of January 1, 1939. This gives us a differential due to tax-exemption of about one-half of 1 percent, if the quality of the bonds compared is about the same. This provides a maximum differential, for it would be difficult to contend that the best corporates are as good as the best municipals. All of these things unfortunately involve opinion because we do not have exactly comparable securities.

Senator AUSTIN. That is just the point, the premises are not identical and they are not analagous.

Mr. MURPHY. Yes, they are, Senator.

Senator AUSTIN. But they are not identical; the premises are not identical.

Mr. MURPHY. Professor Lutz does not state his premises with respect to the difference between municipal and corporation securities. I cannot say, of course, that his premises are identical.

Senator AUSTIN. We can see that, of course.

Mr. MURPHY. Do you not think that if tax-exemption were not an issue, the cream of the crop of municipal bonds would not be considered more generally desirable bonds than the cream of the corporation bonds. It is my impression that municipal bonds are at least as good and possibly better, in which case there is a differential of about one-half of 1 percent in yield. That is a question every man may have his own opinion on.

Senator MILLER. I want to ask you one question. Refer to your table I, and taking the years beginning with 1932, and the differential of municipal bonds, those were tax-free bonds?

Mr. MURPHY. Yes, sir.

Senator MILLER. Now, take the yield on high-grade corporation bonds, I notice that the differential there was three one-hundredths percent.

Mr. MURPHY. Three one-hundredths less than nothing, in 1934.

Senator MILLER. Yes, there is minus. How do you account for that—what we have been listening to here?

Mr. MURPHY. That differential is what we would call a gross differential. Now, you ask what it is due to. It is due in part to the market credit in evaluation, and in part to tax exemption.

Senator MILLER. Instead of going back to 1900 when the differential was ninety-three hundredths—there was not any differential in this year.

Mr. MURPHY. No, sir.

Senator MILLER. It just looks to me like these figures give you nothing, and it looks to me like that one man's guess is just as good as another.

Mr. MURPHY. You may have something there.

Senator MILLER. I do not mean to disparage the consideration you have given to this thing, but, I am looking at it from the standpoint of common sense, if I have got any. Now, commencing with 1938 when we had a maximum income tax levy of 79 percent the differential is twenty-eight one-hundredths.

Mr. MURPHY. That is right.

Senator MILLER. I just cannot reconcile some of the other figures we have had shown up the last week with those figures.

Mr. MURPHY. Sometimes nothing is something. It seems to me these tables indicate more clearly than anything else that these differentials are due to things other than tax exemption.

Senator MILLER. That is what I would assume.

Mr. MURPHY. If they were due to tax exemption you would expect them to tie in to what was in the last column, but if you look at it, it does not work out that way.

Senator MILLER. These tables would indicate that it is outside influences or conditions, more than the question of exemptions that controls the price and interest rate.

Mr. MURPHY. That is what is proved.

Senator MILLER. Thank you.

Mr. MURPHY. In conclusion, we see no reason to revise our estimate of $59,000,000 to $155,000,000 as the range of the total increase in interest cost which would be incurred by the Federal and by all State and local governments as a result of the elimination of the tax-exemption privilege after all the now outstanding debt had been retired and had been replaced by new taxable securities. This is, of course, in no way intended as a forecast that such exact replacement will actually take place.

The maximum estimate of increased interest cost is well below our minimum estimate of the annual increase in revenue to the Federal Government alone. However, as Mr. Hanes emphasized in his statement, we consider this relatively unimportant compared with the more equitable distribution of the tax burden and the other desirable economic effects which would be secured by stopping the further issuance of tax-exempt securities.

The CHAIRMAN. Thank you, Mr. Murphy. Any further questions by any member of the committee?

Senator AUSTIN. No. I think we should thank the witness for his work on this subject, and for his honest statement, and I appreciate it very much, although I have asked him many questions. I think he has helped us a great deal.

The CHAIRMAN. I think Senator Austin expresses the feeling of this committee and we thank you very much.

(The examples and memorandums referred to by Mr. Murphy are as follow:)

COMMENTS ON THE EXAMPLES USED BY MR. W. E. KERSHNER TO MEASURE THE DIFFERENCE IN YIELD BETWEEN BONDS SUBJECT TO AND BONDS EXEMPT FROM THE OHIO TAX ON INCOME FROM INTANGIBLE PROPERTY

In his statement on Federal Taxation of State and Municipal Bonds, presented before the Special Committee of the Senate on Taxation of Governmental Securities and Salaries on February 8, 1939, Mr. Kershner purports to show that "it is conservative to say that the spread is 0.75 percent" between the yields of Ohio bonds that are subject to, and those that are exempt from, the State tax of 5 percent on income from intangible property.

The quotations which he uses were all "during the last 3 months of 1938." It should first be noted that there are some difficulties in comparing the yields of two securities on different dates in a period when the market is moving rapidly as was the case with municipal bonds during the last quarter of 1938. On October 1, 1938, the Bond Buyer's index of yields of the bonds of 11 first-grade cities was 2.57 percent; by January 1, 1939, it had declined to 2.36 percent, a change of 0.21 percent. This, of course, represents an average movement whereas the bonds of any one municipality may have moved substantially more or less than this. It is clear that by taking a quotation for a taxable Ohio security as of October 1, 1938, and a quotation for a tax-exempt security as of January 1, 1939, a differential of as much as 0.21 percent, on the average, could be obtained—and this differential would have no bearing whatsoever upon the market's evaluation of the tax-exemption feature but would merely reflect the decreasing yield of municipal bonds in general. With this in mind, Mr. Kershner's examples may be taken up one by one in the order which he gives them.

AKRON

Mr. Kershner says:

"Akron tax-free 4-percent bonds, due in 1942, were offered on a 3-percent basis, while Akron taxable 4¾-percent bonds, due in 1944, were offered at 4.40 percent, and 4½-percent bonds, due in 1940, were offered at 4.35 percent."

The tax-exempt Akron 4's of 1942 are water bonds. According to the Bank and Quotation Record, Akron water bonds (protected by the revenues from waterworks as well as by their status as general obligations) sell at substantially lower yields than do the other Akron obligations. This probably explains most of the spread between the bonds cited by Mr. Kershner. This belief is substantiated by the differential indicated between taxable water bonds and taxable general obligations of Akron. On December 31, 1938, Akron 5-percent taxable water bonds, running serially from 1939 to 1953, yielded from 2 percent to 3.80 percent, whereas other taxable Akron bonds ranging from 4¼'s to 5½'s, and running from 1939 to as late as 1956, yielded from 4 percent to 4.60 percent.

CINCINNATI

Mr. Kershner says:

"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 * * *."

It is very difficult to understand the meaning of Mr. Kershner's statement that "Cincinnati taxable bonds were selling around 2 percent." Obviously, bonds—particularly short-term bonds—must be compared with securities of about the same maturity, for interest rates at the present time are very much lower for short-term than for long-term securities. In this connection it is interesting to note the wide variance in yield between Treasury bonds of different maturities, as shown in the following table. The yield quotations are as of December 31, 1938.

Date upon which first callable:	Yield to earliest call date (percent)
Mar. 15, 1941	0.23
June 15, 1943	1.06
Sept. 15, 1945	1.62
Sept. 15, 1950	2.23
Mar. 15, 1955	2.53

We have, therefore, endeavored to make a comparison of a Cincinnati taxable bond of somewhat comparable maturity with the tax-exempt 4's of 1942, but we are not able to even approximate Mr. Kershner's quotation. The closest maturities to 1942 which we have located in the Bank and Quotation Record are taxable Cincinnati 5¼'s of 1941 which yielded 1.[illegible]5 percent and taxable 4½'s of 1943 which yielded 1.30 percent on December 31, 1938. These yields may be compared with the 2-percent yield for taxable bonds cited by Mr. Kershner.

Mr. Kershner continues:

"* * * 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."

The tax-free 3½'s of 1965, however, are callable, perhaps as early as 1942, and certainly as early as 1946, depending upon which of several possible issues Mr. Kershner may have had in mind. The taxable 5's, on the other hand, are not callable prior to their final maturity in 1965. Hence the maturities of the two securities are not comparable.

The prices corresponding to the yields quoted by Mr. Kershner are from about 107 to about 113 for the tax-free 3½'s, depending upon earliest call date, and about 152 for the taxable 5's. If, by chance, the tax-free bonds should not be called and should run to their final maturity in 1965, they would give the relatively high yield of from about 2.85 percent to about 3.10 percent, or at least 0.50 percent more than that on the taxable bonds. The yield on the taxable 5's, on the other hand, is prevented from declining further than it has by the somewhat astronomic premium of about 52 points.

CLEVELAND

Mr. Kershner says:

"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."

Mr. Kershner's Cleveland example is the only one in which there is not apparent upon the face of the example, as soon as the bonds are identified, adequate reason based on other causes to account for all or the major portion of the differential ascribed by him to tax exemption. We have, however, made an effort to verify Mr. Kershner's quotations, as they seem to be greatly at variance with the results elsewhere. An examination of all of the quotations for October, November, and December 1938, as published in the Bank and Quotation Record of the Commercial and Financial Chronicle, the most comprehensive generally published source of municipal-bond quotations, fails to show any Cleveland bonds maturing in the 1950's yielding less than 3 percent in October and November and 2.80 percent in December. It is, therefore, not possible to comment further on the Cleveland example.

COLUMBUS

Mr. Kershner says:

"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."

The unfairness of comparing the yields of 9-year tax-exempt bonds with the yields of 19-year taxable bonds may be clearly seen by referring to the table on Treasury-bond yields for various maturities presented in connection with the discussion of Mr. Kershner's Cincinnati examples. Using exactly the same method of analysis, Mr. Kershner could have taken a long-term tax-exempt bond and a short-term taxable bond and wound up with exactly the opposite conclusion—that is, that taxable bonds sell on a lower yield basis than tax-exempt bonds.

Furthermore, the tax-free Columbus 4's of 1947 are waterworks bonds, about which Moody's 1939 Governments has this to say: "It was reported that earnings from the water system are sufficient to cover interest charges and sinking-fund requirements on waterworks bonds, which in addition are a general obligation of the city."

TOLEDO

Mr. Kershner has this to say:

"Toledo tax-free 4-percent bonds, due in 1942, were offered at 2.00 percent, while Toledo taxable 4½-percent bonds, due in 1948, were offered at 2.80 percent, and those due in 1951 were offered at 3.00 percent and 3.10 percent."

Here again, bonds which are in no way comparable with respect to maturity have been used. It is interesting to note what a similar comparison between United States obligations shows. As of December 31, 1938, United States Treasury 3⅜-percent bonds of June 15, 1943–47, yielded 1.06 percent to earliest call date and the 3-percent bonds of September 15, 1951–55, yielded 2.33 percent to earliest call date. This is a differential of 1.27 percent due entirely to the difference in length of term of the securities. How then, is Mr. Kershner able to find that the market places any value at all upon the Ohio tax-exemption privilege when his differential of only 1.10 percent seems scarcely adequate to account for the differences in maturity?

Comments on the Estimates Presented by Professor Lutz Regarding the Additional Interest Cost Which Would Result From the Removal of Tax Exemption From Future Issues of Public Securities

I. INCREASE IN INTEREST COST WHICH WOULD RESULT FROM THE IMPOSITION OF FEDERAL INCOME TAXES ON INCOME FROM STATE AND LOCAL SECURITIES

Professor Lutz first takes up the matter of increased interest cost on long-term State and local securities. For this purpose, he makes several approaches to estimate the interest differential resulting from tax exemption.

First, he presents the results of a questionnaire he submitted to 13 dealers and to 4 insurance companies requesting their opinions of the probable increase in interest cost which would result if tax exemption were removed on 27 specified State and local bonds. The variations in the replies which he received serve to indicate how tenuous the measurement of the differential actually is. Thus, the range of the dealers' estimates of the average differential on the group of issues was from slightly less than thirty one-hundredths of 1 percent to a full 1 percent, with the average at sixty-one one-hundredths of 1 percent. The estimates of the insurance companies ranged from just below forty-six one-hundredths of 1 percent to almost eighty-six one-hundredths of 1 percent, the average being sixty-eight one-hundredths of 1 percent.

With respect to these estimates Professor Lutz says that they "constitute opinion evidence only" and that "they may be criticized as inconclusive, notwithstanding the peculiar qualifications which may be possessed by those who responded to the questionnaire." He then says that "another and more objective test is supplied by the bond market itself," and he introduces certain series of yields on municipal bonds and high-grade corporate bonds. Unfortunately, neither his tables nor his charts present the amount of the differential existing in favor of municipal bonds, but that may be explained by the fact that this differential is never really used. That is, after saying that the market provides a "more objective test," Professor Lutz never actually mentions the differential as indicated by the market. This is interesting, because the figures in his tables show quite conclusively that the differential fluctuates far too violently to reflect the value of the tax-exemption privilege alone. These fluctuations are due almost entirely to changes in the credit ratings assigned by the market to the State and local bonds as compared with the corporate bonds. The implication, however, is that the tables support the estimate of Professor Lutz that the differential is sixty one-hundredths of 1 percent, and that no discussion of the data is called for. An examination of the differentials obtained by subtracting the municipal index from the corporate index shows how weak this inference really is.

For example, his comparison of Moody's Aaa corporate bonds and the Bond Buyer Index for 11 first-grade cities during the last 11 years shows a yield differential ranging from negative twenty-seven one hundredths of 1 percent in May 1933, to positive one and eleven one-hundredths of 1 percent in October 1931. The differential jumps up and down remarkably. From December 1931 to January 1932, for example, it drops from one and nine one-hundredths of 1 percent to fifty-four one hundredths of 1 percent, or about half. Then from March to April it more than doubles, going from thirty-seven one-hundredths to seventy-seven one-hundredths of 1 percent; and increases almost as much again in May when the differential becomes one and six one-hundredths of 1 percent. Again, from October to November 1934, the differential almost doubles; while from September to October 1935, it decreases by almost half. In 4 months of the period the differential was negative—that is, corporate bonds sold on a lower yield basis than municipal bonds.

It is interesting to compare the size of the differential before and after the passage of the Revenue Act of 1932, which increased the maximum individual income tax rate from 25 to 63 percent. It might be expected that the differential would show an increase as a result of this increase in tax rate. In the year 1931 the differential had averaged about seventy one hundredths of 1 percent; but in the year 1933 it averaged only twenty one-hundredths of 1 percent. There is certainly no indication here that the higher rates of the Revenue Act of 1932 influenced the differential; but the indication is rather that changes in credit ratings overshadow the tax exemption in importance.

In the other table of market data which Professor Lutz introduces, we find a very interesting comparison of the yields on 15 first-grade municipal bonds and high-grade public-utility (A 1+) bonds as computed by Standard Statistics Co. Comparing these two series for the first 8 months of 1938, which is as far as the figures are given, we find that the municipal bonds average three one-hundredths of 1 percent higher in yield than the public-utility bonds. In other words, the differential was negative three one-hundredths of 1 percent. Professor Lutz also presents the Standard Statistics series on A 1+ industrial bonds, on A 1+ railroad bonds and an average of all A 1+ corporation bonds, but the public utility bond series has been cited here because such bonds are higher grade than the other private securities.

There are attached hereto copies of the two tables on yields presented by Professor Lutz, to which have been added the differentials between municipal and corporate bonds.

After this interlude on market data, Professor Lutz says: "* * * all of the above estimates represent the opinions of the various groups as to just how much shifting can be accomplished. A measure of this shifting can be sought in the tax rates themselves." He then refers to the fact that his estimates show that 35 percent is "approximately the average or effective tax rate which would have been levied on all State interest deemed * * * to have been received in 1937 by individuals with net incomes of $5,000 and over." In other words, in estimating the revenue which would be derived from the removal of tax exemption from State and local governmental securities, Professor Lutz says that individuals with incomes of $5,000 and over would pay an average rate of about 35 percent. This rate of 35 percent, however, seems to have been in-correctly computed, for Professor Lutz, in connection with his revenue estimates, says: "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." This is an average rate of 23 percent, not 35 percent.

In any event, Professor Lutz says that 35 percent of the average municipal bond yield of 2.60 percent would be ninety-one one-hundredths of 1 percent, which would be the amount of the tax which individuals would attempt to shift by demanding higher interest rates. Similarly, with the corporation income tax at 16½ percent, he finds that corporations would endeavor to shift a tax of about forty-one one-hundredths of 1 percent. Then he says: "An average of these extremes would be 66 points, which almost coincides with the average of the insurance company estimates of the effect of the Federal tax."

It should be noted that this estimate of a differential of 66 points is not an attempted measurement of what the market now accords to the privilege of tax exemption, but is an estimate of the tax which would be paid if State and local securities were not tax exempt. The two concepts are quite different, for it is entirely possible for the tax-exemption privilege to be valued at zero in the market, for the reason that those purchasers who derive no benefit from tax exemption would logically refuse to pay a higher price because of the tax-exemption privilege, while investors who did derive some benefit from tax exemption would then be paying no extra price because of the tax exemption. Consequently, the revenue loss might be large, while the interest saving to governments would be nil. It is obvious, therefore, that this method can throw absolutely no light on the additional interest cost to State and local governments which would result from the subjection to the Federal income tax of interest from State and local securities.

On the basis of these various data, Professor Lutz suggests 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." He then applies sixty one-hundredths of 1 percent to the long-term debt of State and local governments to obtain an estimated increase of interest cost of $111,000,000.

The accuracy of this estimate depends entirely on whether the sixty one-hundredths of 1 percent differential Professor Lutz uses is reasonable. Certainly he has not demonstrated that it is; and his explanation of the derivation of the differential is quite unsatisfying.

On the short-term debt of State and local governments, Professor Lutz guesses that the interest rate would be boosted twenty one-hundredths of 1 percent if tax exemption were removed. Applied to the $890,500,000 of such debt outstanding in 1937, an estimate of $1,800,000 of added interest cost is provided.

II. INCREASE IN INTEREST COST WHICH WOULD RESULT FROM THE IMPOSITION OF STATE INCOME TAXES ON INCOME FROM FEDERAL SECURITIES

Turning now to the estimated increase in interest cost on the securities of the United States Government and its instrumentalities, which would result from the subjection of interest on such securities to State income taxes, we find Professor Lutz doing some interesting reasoning. He cites no statistics as to the market valuation of the present exemption, and relies entirely on deductive reasoning in making the estimate of the increased interest cost. His reasoning in this connection is interesting because if he had applied it to the present situation, Professor Lutz would have found that no differential in favor of Federal securities can exist today as a result of the exemption of interest thereon from State income taxes.

The reasoning in point can be summarized in one sentence. Professor Lutz says that if Federal bond interest were subjected to State income taxes, the price of Federal bonds would tend to be set by the purchasers in States levying income taxes, rather than by the purchasers in nonincome tax States. This is logical, for there can only be one price and it cannot be higher than those purchasers are willing to pay who stand to receive the least net return after allowing for taxes.

The application of this reasoning to the present situation is somewhat complex but it proves conclusively that no yield differential can now exist with respect to Federal securities because the interest thereon is exempt from State income taxes. At present, those purchasers who live in States leving income taxes on other income receive a greater benefit from interest on Federal securities than persons in States not levying any income taxes. The monetary return is the same in both cases, but the purchaser in an income-tax State at present derives a special benefit because if he invested in a private security, he would be taxed on his interest income, but his Federal bond interest is exempt from the State income tax. On the other hand, the investor in a State which levies no income tax receives no State tax advantage on Federal bond interest as compared with interest from private securities. Hence, the purchasers in nonincome-tax States now derive the least benefit tax-wise from the State tax exemption on Federal securities—that is, no benefit at all—and they accordingly set the price for such securities, the price they are willing to pay making no allowance for the exemption from State income taxes.

An illustration will serve to clarify the reasoning. Assume that only the Eastern States levy an income tax and that it consists of a uniform 5-percent rate on all income, but that this tax does not apply to any Federal bonds which might be issued. Suppose that there are no Federal securities outstanding until the Federal Government issues a small amount of bonds at 4 percent which we shall suppose to be the standard rate of interest for riskless investments. The tendency will be for this bond to be purchased almost entirely by persons living in the Eastern States, because it will provide a yield equivalent to a private security with an interest rate of 4.21 percent. That is, a private security with an interest rate of 4.21 percent will yield 4 percent after taxes. Investors in the States which do not levy an income tax, however, will compare the 4-percent yield on the Federal security with a 4 percent yield on a private security, inasmuch as they do not have to consider income taxes. Investors in the Eastern States will compete against each other for the Federal security, and, since the supply is limited, will drive the price up, and the yield will consequently decrease. The yield will tend to go to 3.80 percent, the net return after taxes on a 4-percent taxable bond.

Under these conditions, the Federal Government could have issued the bond originally with a 3.80-percent interest rate. It should be noted, however, that the basic interest rate of 4 percent would not have changed—rather, the Federal Government would be borrowing at a rate lower than the basic rate because of the exemption of interest from income taxes levied by the States. Moreover, the purchasers would be in the same position as they would have been if the Federal interest had been subject to the State income tax, for the tax saving would be exactly offset by the lower interest rate. It should be noted, however, that the Federal Government would here be gaining at the expense of the States, since the States would lose the tax revenue, but the Federal Government would save a corresponding amount in interest.

Now assume that the Federal Government issues a much larger amount of the same bond, so that investors in the Eastern States are unable to absorb the full supply and some have to be sold to investors in the Western States. The latter investors will be unwilling to accept a yield of less than 4 percent, since that is the yield they can obtain on comparable private securities and the price will therefore have to be on a 4-percent basis. Inasmuch as there can be only one price, the holders in the Eastern States will now get the bond at a price which does not reflect the value of the tax exemption to them.

Under these conditions, the Federal Government will derive no saving, because interest on its bonds is exempt from the income taxes levied in the Eastern States. True, the States will continue to lose revenue, but the advantage will inure solely to the purchasers in the States levying income taxes.

Accordingly, following Professor Lutz's reasoning, there can be no saving in interest cost at present to the Federal Government, because the interest on its securities is exempt from State income taxes, for some of its bonds have to be held by persons in States which levy no income taxes. Consequently, Professor Lutz would have to conclude that there could be no increase in interest cost to the Federal Government if interest on its securities were made subject to State income taxes, and he should reduce his figure of $30,000,000 as the estimate of such cost to zero.

III. INCREASE IN INTEREST COST WHICH WOULD RESULT FROM THE IMPOSITION OF FEDERAL INCOME TAXES ON INCOME FROM FEDERAL SECURITIES

Having considered the estimates of the increased interest cost to the States resulting from Federal taxation of the interest on State and local securities, and the increased interest cost to the Federal Government resulting from the subjection of interest on Federal securities, to State income taxes, there remain for consideration the estimates which Professor Lutz made respecting the additional interest cost to the Federal Government resulting from the subjection of the interest on its securities to Federal income taxes. He makes no attempt to figure what the market differentials are at the present time because of the exemption from Federal income taxes. Instead, he estimates the additional interest cost on the basis of the percentage tax which corporations and individuals would pay on Federal interest.

Professor Lutz says that corporations "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." The rate for individuals, he explains, was determined on the basis of his estimates of the revenue which would be derived by the Federal Government from these individuals if Federal interest received by them were subject to tax. Applying these average tax rates to the present long-term yield basis of Federal securities, that is, 2.40 percent, Professor Lutz finds that the yield basis would be increased by 39.6 points in the case of corporations and by 60 points in the case of individual investors. He then takes an average of these two figures to derive an increase in yield basis of 50 points. Applying this average of fifty one-hundredths of 1 percent to the long-term debt of $28.5 billions, he derives an estimate of 142.6 millions for the increase in interest cost on long-term Federal securities.

It has been pointed out previously that the increased cost due to the taxation of the interest on public securities will be determined by the size of the present differential due to tax exemption and not by the amount of the tax to the holders of public securities. This must be so, since the differential can be only one amount at a given time, and yet the tax saving will vary among investors according to the income-tax rates to which they are subject. The size of the differential is determined by the investor who derives the least benefit from tax exemption, for he would not logically pay more for it than it is worth to him. Consequently, those investors who value the tax-exemption privilege higher than the price at which it is set are getting something for nothing.

It is clear then, that the idea of estimating the increased interest cost on the basis of the expected tax which investors would try to shift if public securities were made taxable is simply not reasonable.

Besides the fundamental error in principle underlying the technique employed, it also develops that the technique has been improperly used. In applying his methodology, Professor Lutz has ignored entirely the fact that Treasury bonds and the bonds of most Federal instrumentalities are partially exempt rather than wholly exempt from Federal income taxes. Our records show that partially exempt securities were outstanding on June 30, 1937, in the amount of $29.1 billions and that practically all of these securities were long-term.

Partial tax exemption means that interest received by individuals is exempt only from the normal tax of 4 percent, and not from surtaxes,[1] and for the corporation income tax, it means the same thing as full tax exemption. Consequently, individuals would not pay an average tax of 25 percent on such interest if it were taxed, as Professor Lutz asserts, but would pay an additional tax of no more than 4 percent.

On the basis of an average yield of 2.40 percent, a tax of 4 percent would aggregate 9.6 points. Application of Professor Lutz's methodology of averaging the number of points representing the tax for corporations and for individuals would produce an average of 24.6 points or approximately half the figure which Professor Lutz used. This would provide an estimate of the additional interest cost on partially exempt Federal securities of about $70,000,000, but even this figure is too high.

The fact is, as has already been pointed out, that no investor will logically pay an increased price on a security because of the tax-exemption privilege to an extent higher than the exemption is actually worth to him. Inasmuch as the partial tax exemption is worth less to individuals than to corporations, the market value of the exemption will be determined by individual investors. On this basis, the price should reflect the value of the partial tax-exemption privilege either as zero on the basis of the value to the investors not paying a Federal income tax, or at 4 percent of the yield on the basis of the value to individual owners. Consequently, rather than to average the tax value to individuals and to corporations, it would seem more logical to take the tax value to individuals alone. We have previously pointed out that this is 9.6 points, or about one-fifth of the figure which Professor Lutz used for computing the additional interest cost to the Federal Government. On this basis, the estimate of the extra interest cost on partially exempt securities would be $29,000,000.

It is interesting to note that, if we should accept Professor Lutz's estimate of one-half of 1 percent as the value of the differential due to partial tax exemption, we would soon find ourselves in an anomalous position. The yield differential between long-term Treasury and high-grade long-term corporate bonds is not

[1] Ignoring the minor exception that interest on Treasury bonds to the principal amount of $5,000 is exempt from surtax as well as normal tax.

nearly as high as one-half of 1 percent. Hence a differential of one-half of 1 percent attributed to the partial tax exemption privilege results in the absurd supposition that the Treasury bonds are not really as good and as safe securities as corporate bonds but sell on a lower yield basis, because the partial tax-exemption privilege more than makes up for their poor quality.

The estimated increase in interest cost on wholly exempt long-term Federal securities must next be considered.

On June 30, 1937, wholly exempt bonds of the Federal Government and its instrumentalities were outstanding in the amount of approximately $2.2 billions. Applying Professor Lutz's figure of fifty one-hundredths of 1 percent to estimate the increased interest costs on these securities if income thereon were made subject to Federal income tax, we arrive at a figure of about $11,000,000. Adding this to the revised estimate of $29,000,000, representing the extra interest cost on partially exempt long-term securities, provides an estimate of the total increase in interest cost on long-term Federal securities of around $40,000,000.

In the case of short-term securities of the Federal Government and its instrumentalities, Professor Lutz estimated the additional interest cost which would arise through application of the Federal income tax on notes only, suggesting that the effect on bills would be negligible. For notes, he assumed that the yield basis would go up ten one-hundredths of 1 percent. On the basis of present yields an increase of 10 points would represent about a 62-percent increase. Such an increase is inconceivable. The tax-exemption feature of these securities is not important in determining their yield or distribution, as financial corporations furnish an insistent demand for high-grade short-term instruments, and Treasury notes constitute by far the greater proportion of all such instruments available for purchase. As a matter of fact, most insurance companies and a large proportion of banks are unable at present to derive any value from the tax-exemption feature on additional purchases of public securities. Consequently, it is likely that the market prices of the notes reflect only a very negligible differential for the value of a tax-exemption privilege which many purchasers find of no use. In short, Professor Lutz's estimate of $15,000,000 as the increase in interest costs on short-term Federal securities is very much too high.

Monthly Yield Basis, Moody's Triple A Corporate Bonds, the Bond Buyer Index for 11 cities, and average yield of outstanding Treasury bonds

[A table included in appendix B of a report submitted by Professor Lutz, to which has been added the differential by which the Corporate Index exceeds the Index of 11 Cities]

Year	Treasury bonds	Municipal bonds	Corporate bonds	Differential by which corporate index exceeds municipal index
1928				
January	3.18	3.83	4.46	0.63
February	3.19	3.83	4.46	.63
March	3.17	3.83	4.46	.63
April	3.20	3.85	4.46	.61
May	3.24	3.87	4.49	.62
June	3.29	3.97	4.57	.60
July	3.42	4.02	4.61	.59
August	3.49	4.12	4.64	.52
September	3.46	4.15	4.61	.46
October	3.48	4.12	4.61	.49
November	3.39	4.12	4.58	.46
December	3.46	4.08	4.61	.53
1929				
January	3.52	4.13	4.62	.49
February	3.62	4.17	4.66	.49
March	3.74	4.23	4.70	.47
April	3.63	4.31	4.69	.38
May	3.64	4.23	4.70	.47
June	3.69	4.27	4.77	.50
July	3.64	4.30	4.77	.47
August	3.70	4.30	4.79	.49
September	3.68	4.40	4.80	.40
October	3.68	4.47	4.77	.30
November	3.36	4.33	4.76	.43
December	3.37	4.26	4.69	.43

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	Differential by which corporate index exceeds municipal index
1930				
January	3.43	4.19	4.66	0.47
February	3.41	4.25	4.69	.44
March	3.29	4.21	4.62	.41
April	3.36	4.10	4.60	.50
May	3.30	4.12	4.60	.48
June	3.24	4.13	4.57	.44
July	3.23	4.07	4.52	.45
August	3.25	4.02	4.47	.45
September	3.23	3.96	4.42	.46
October	3.20	3.92	4.42	.50
November	3.17	3.93	4.47	.54
December	3.20	4.00	4.52	.52
1931				
January	3.17	4.05	4.42	.37
February	3.27	3.98	4.43	.45
March	3.26	3.95	4.39	.44
April	3.24	3.82	4.40	.58
May	3.13	3.75	4.37	.62
June	3.10	3.60	4.36	.76
July	3.11	3.70	4.36	.66
August	3.13	3.70	4.40	.70
September	3.24	3.70	4.55	.85
October	3.62	3.88	4.99	1.11
November	3.59	4.11	4.94	.83
December	3.92	4.23	5.32	1.09
1932				
January	4.32	4.66	5.20	.54
February	4.11	4.65	5.23	.58
March	3.91	4.61	4.98	.37
April	3.66	4.40	5.17	.77
May	3.71	4.30	5.36	1.06
June	3.73	4.42	5.41	.99
July	3.55	4.46	5.26	.80
August	3.42	4.25	4.91	.66
September	3.38	4.08	4.70	.62
October	3.39	4.02	4.64	.62
November	3.39	4.04	4.63	.59
December	3.31	4.04	4.59	.55
1933				
January	3.19	3.81	4.44	.63
February	3.29	3.88	4.48	.60
March	3.44	4.26	4.68	.42
April	3.43	4.44	4.78	.34
May	3.31	4.90	4.63	−.27
June	3.22	4.48	4.46	−.02
July	3.20	4.30	4.36	.06
August	3.21	4.20	4.30	.10
September	3.20	4.12	4.36	.24
October	3.22	4.20	4.34	.14
November	3.46	4.26	4.54	.28
December	3.53	4.64	4.50	−.14
1934				
January	3.50	4.50	4.35	−.15
February	3.32	4.06	4.20	.14
March	3.21	3.99	4.13	.14
May (sic)	3.01	3.66	4.01	.35
April (sic)	3.12	3.84	4.07	.23
June	2.94	3.61	3.93	.32
July	2.85	3.49	3.89	.40
August	2.99	3.50	3.93	.43
September	3.20	3.60	3.96	.36
October	3.08	3.67	3.90	.23
November	3.05	3.42	3.86	.44
December	2.97	3.38	3.81	.43

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	Differential by which corporate index exceeds municipal index
1935				
January	2.83	3.30	3.77	0.47
February	2.73	3.19	3.69	.50
March	2.69	3.15	3.67	.52
April	2.64	2.90	3.66	.76
May	2.61	2.93	3.65	.72
June	2.61	2.98	3.61	.63
July	2.59	2.85	3.56	.71
August	2.66	2.81	3.60	.79
September	2.78	2.94	3.59	.65
October	2.77	3.16	3.52	.36
November	2.73	2.95	3.47	.52
December	2.73	2.79	3.44	.65
1936				
January	2.68	2.84	3.37	.53
February	2.62	2.73	3.32	.59
March	2.54	2.66	3.29	.63
April	2.51	2.69	3.29	.60
May	2.50	2.76	3.27	.51
June	2.50	2.61	3.24	.63
July	2.50	2.66	3.23	.57
August	2.43	2.60	3.21	.61
September	2.41	2.59	3.18	.59
October	2.42	2.53	3.18	.65
November	2.29	2.54	3.15	.61
December	2.27	2.35	3.10	.75
1937				
January	2.29	2.35	3.10	.75
February	2.31	2.49	3.22	.73
March	2.50	2.63	3.32	.69
April	2.74	2.90	3.42	.52
May	2.67	2.81	3.33	.52
June	2.64	2.77	3.28	.51
July	2.59	2.70	3.25	.55
August	2.59	2.62	3.24	.62
September	2.67	2.60	3.28	.68
October	2.65	2.69	3.27	.58
November	2.60	2.76	3.24	.48
December	2.54	2.74	3.21	.47
1938				
January	2.47	2.75	3.17	.42
February	2.46	2.66	3.20	.54
March	2.45	2.61	3.22	.61
April	2.43	2.72	3.30	.58
May	2.30	2.61	3.22	.61
June	2.31	2.58	3.26	.68
July	2.34	2.51	3.22	.71
August	2.32	2.49	3.18	.69
September	2.40	2.51	3.21	.70
October	....	2.57	3.15	.58

Average bond yields as computed by Standard Statistics, Inc.

[A table included in appendix C of a report submitted by Professor Lutz, to which has been added the differential by which the public-utility index exceeds the index for municipal bonds]

Year	15 first-grade municipal bonds	Industrial A1+ bonds	Railroad A1+ bonds	Public utilities A1+ bonds	Average, all A1+ corporation bonds	Differential by which public-utility index exceeds municipal index
1936						
January	3.27	3.39	3.47	3.38	3.41	0.11
February	3.22	3.36	3.45	3.32	3.38	.10
March	3.18	3.36	3.42	3.29	3.36	.11
April	3.17	3.33	3.38	3.25	3.32	.08
May	3.16	3.37	3.39	3.23	3.33	.07
June	3.16	3.37	3.39	3.21	3.32	.05
July	3.13	3.33	3.33	3.21	3.29	.08
August	3.06	3.31	3.35	3.21	3.29	.15
September	2.07	3.30	3.32	3.18	3.27	1.11
October	2.94	3.29	3.29	3.15	3.24	.21
November	2.85	3.28	3.27	3.16	3.24	.31
December	2.76	3.20	3.20	3.12	3.17	.36
1937						
January	2.79	3.20	3.28	3.07	3.18	.28
February	2.96	3.17	3.30	3.08	3.18	.12
March	3.19	3.26	3.37	3.09	3.24	−.10
April	3.24	3.37	3.50	3.22	3.36	−.02
May	3.14	3.44	3.55	3.23	3.41	.09
June	3.11	3.34	3.45	3.15	3.31	.04
July	3.07	3.28	3.51	3.14	3.31	.07
August	3.01	3.25	3.41	3.10	3.25	.09
September	3.18	3.30	3.45	3.08	3.28	−.10
October	3.24	3.34	3.49	3.10	3.31	−.14
November	3.17	3.53	3.61	3.13	3.39	−.04
December	3.15	3.49	3.58	3.07	3.38	−.08
1938						
January	3.03	3.32	3.49	2.96	3.26	−.07
February	2.99	3.25	3.52	2.95	3.24	−.04
March	2.99	3.05	3.43	2.91	3.13	−.08
April	3.03	3.17	3.64	2.91	3.24	−.12
May	2.91	3.11	3.60	2.92	3.21	.01
June	2.91	3.08	3.60	2.89	3.19	−.02
July	2.87	3.17	3.66	2.89	3.24	.02
August	2.82	3.05	3.58	2.87	3.17	.05
September	....	3.07	3.53	2.79	3.13	....

MEMORANDUM ON THE METHOD OF DETERMINING THE DIFFERENCE IN YIELD BETWEEN TAXABLE AND TAX-EXEMPT SECURITIES

[Source: Treasury Department, Division of Research and Statistics]

In order to measure exactly the value which the market is placing upon the tax-exemption feature of public securities, we ought to compare securities which are identical in every respect save that of tax exemption. Unfortunately, this is impossible, inasmuch as governmental securities differ from taxable securities in many respects aside from the tax status itself. At one time, such a comparison could be made between the partially tax-exempt 4¼-percent First Liberty Loan converted bonds, 1932–47, and the wholly tax-exempt 3½-percent First Liberty Loan bonds, 1932–47.[1] But no such comparison is possible today. There are other ways, however, of arriving at an estimate of the value of the tax-exemption privilege, as, for instance, for short-term securities, by comparing partially tax-exempt Treasury bonds with wholly tax-exempt Treasury notes, or for long-term securities, by comparing wholly tax-exempt State and municipal bonds with taxable high-grade corporation bonds and with partially tax-exempt Treasury bonds.

The differentials between the yields of fully taxable, partially tax-exempt, and wholly tax-exempt securities relevant for our purposes ought, strictly speaking, to be measured in a market not anticipating any hindrance in the future issuance of tax-exempt securities, since any such anticipation would tend to produce some additional differential not relevant for our purposes. It would appear on a priori grounds that the present market may be making some allowance for the possibility that future issuance of tax-exempt securities may be shut off, and this supposition

[1] The figures are not cited here because they are not relevant at this time.

gains some support from the fact that the Bond Buyer's index of the yields of 11 high-grade municipal bonds, which was one one-hundredth of 1 percent higher than the yield of the partially tax-exempt Treasury 2¾'s of 1955–60 on the 1st of January 1938—before the President's message on tax exemption could possibly have been forecast—was seventeen one-hundredths of 1 percent lower than the yield of the same Treasury bond by the 1st of January 1939. During the same period, the differential between the municipal-bond index just cited and the Treasury's average of the yields of high-grade corporation bonds, excluding rails, increased from thirty-two one-hundredths of 1 percent to fifty-one one-hundredths of 1 percent.

It appears, therefore, that the present market may be making some allowance for the possibility that future issues of tax-exempt securities may be shut off. Fluctuations in differentials of the magnitude of those cited as evidence of this possibility have, however, on past occasions occurred for reasons entirely independent of tax exemption, and those just cited may be due in their entirety to causes other than anticipation of the cessation of future issuance of tax-exempt securities. This supposition gains some support from the fact that most of the increase in the differentials took place during the fall of 1938 rather than during the spring when the possibility of terminating the issuance of tax-exempt securities first loomed strongly into view. In general, a study of the past history of the differentials serves more to emphasize the relative unimportance of tax exemption in determining the yields of different classes of securities than to cast light on the significance of their most recent movements.

Turning to the present situation, a comparison of the yields of high-grade corporate and high-grade State and municipal bonds throws some light on the present value of tax exemption. As of the 1st of January 1939, the Treasury's average of the yields of high-grade long-term corporation bonds, excluding rails, was 2.87 percent, or fifty-one one-hundredths of 1 percent in excess of the Bond Buyer's index of 11 high-grade municipal bonds as of the same date. This differential can be assigned entirely to the tax-exemption privilege only if the securities compared are of exactly equal desirability in all other respects. Obviously, they are not. The municipal bonds are doubtless superior to the corporates in quality and other attributes apart from that of tax exemption, and the differential of fifty-one one-hundredths of 1 percent thus overstates the market's evaluation of the tax-exemption privilege. As already noted, this differential increased from thirty-two to fifty-one one-hundredths of 1 percent during 1938, which may have been due in part to the effect of the President's message. It appears that it would not be far wrong to assign about one-half of 1 percent as the upper limit of the range of the value attached by the market to the tax-exemption privilege on the supposition of the indefinite continuance of the issuance of tax-exempt securities.

As of the same date—that is, January 1, 1939—the same yield index of high-grade municipal bonds was twenty-three one-hundredths of 1 percent less than the yield of United States Treasury 2¾'s of 1960–65, the most distant maturity of United States securities outstanding. The Treasury bonds, of course, are superior to the municipals in every respect, except that of tax exemption, and are themselves partially tax exempt. As previously noted—by reference to a shorter maturity Treasury bond outstanding during the entire year—this differential for the most part developed during the course of 1938. Nevertheless, making allowance for the higher quality and the partial tax-exemption privilege of the Treasury bonds, it would seem reasonable to set about one-fourth of 1 percent as the lower limit of the range of the value assigned by the market to the full tax-exemption privilege for long-term bonds. This would fix the range at roughly one-fourth to one-half of 1 percent, given the expectation of the market of the unlimited further issuance of tax-exempt securities.

Again, as of the first of January 1939, the yield differential between the 2¾ percent Treasury bond of 1960–65 and the average of high-grade corporates, excluding rails, was twenty-eight one-hundredths of 1 percent. This differential must account for the superior quality, marketability, and other attributes apart from that of tax-exemption of the Treasury bonds as compared with the corporates, as well as the somewhat shorter maturity of the Treasuries, and scarcely seems adequate to account for these things alone with no allowance at all for the tax-exemption privilege. It should be noted here that the partial tax-exemption privilege is not very valuable, since it only results in a tax saving of 4 percent to individuals, and a large proportion of the institutional purchasers are unable to profit by tax-exemption at all at the present time. An allowance of five to fifteen one-hundredths of 1 percent as the market valuation for this privilege would leave a net differential of only thirteen to twenty-three one-hundredths of 1 percent between the yields of the Treasury bond and the corporate bonds to be explained by all the points of superiority of the former over the latter, except that of partial tax exemption. In the absence of better data this seems as reasonable an estimate of the current market evaluation as any.

The preceding discussion has related to long-term securities. The situation with respect to short-term securities appears to be quite different due to the overpowering demand for them on the part of institutional investors to whom tax-exemption is a minor consideration. The 3⅜ percent Treasury bonds, first callable on March 15, 1941, sold on January 1 to yield only three one-hundredths of 1 percent more than the Treasury notes due on the same date, despite the fact that the bonds were selling at a premium of about 7 points as compared with 3 points for the notes, and that the maturity of the notes was firm, whereas that of the bonds was merely an optional call date. With only three one-hundredths of 1 percent total difference in yield, little margin is left to assign any value to the complete tax-exemption privilege of the notes.

On the longer note maturities—say 4 to 5 years—however, there is some evidence—from the extreme flattening of the end of the curve expressing the relationship between yield and maturity—that the complete tax-exemption privilege of the notes has some effect upon their yield. (See chart on "yields of Treasury Bonds and Notes, January 3, 1939.)

To summarize: The market value of the complete tax-exemption privilege on high-grade long-term bonds appears, under present conditions—but assuming the indefinite continuance of the issuance of such securities—to be between one-fourth and one-half of 1 percent, and the market value of the partial tax-exemption privilege with respect to such securities, between five to fifteen one-hundredths of 1 percent. On very short-term securities, the tax-exemption privilege probably has no present market value at all; the value attaching to the tax-exemption privilege after the first several years gradually increasing to the amounts just mentioned.

We will now recess until 2:15 this afternoon.

(Thereupon at 12:20 p. m., a recess was taken until 2:15 p. m.)

AFTERNOON SESSION

The special committee met, pursuant to recess, at 2:15 p. m., Senator Brown (chairman) presiding.

The CHAIRMAN. The committee will come to order.

The next witness will be Dr. Al F. O'Donnell, Assistant Director of Research and Statistics, Treasury Department.

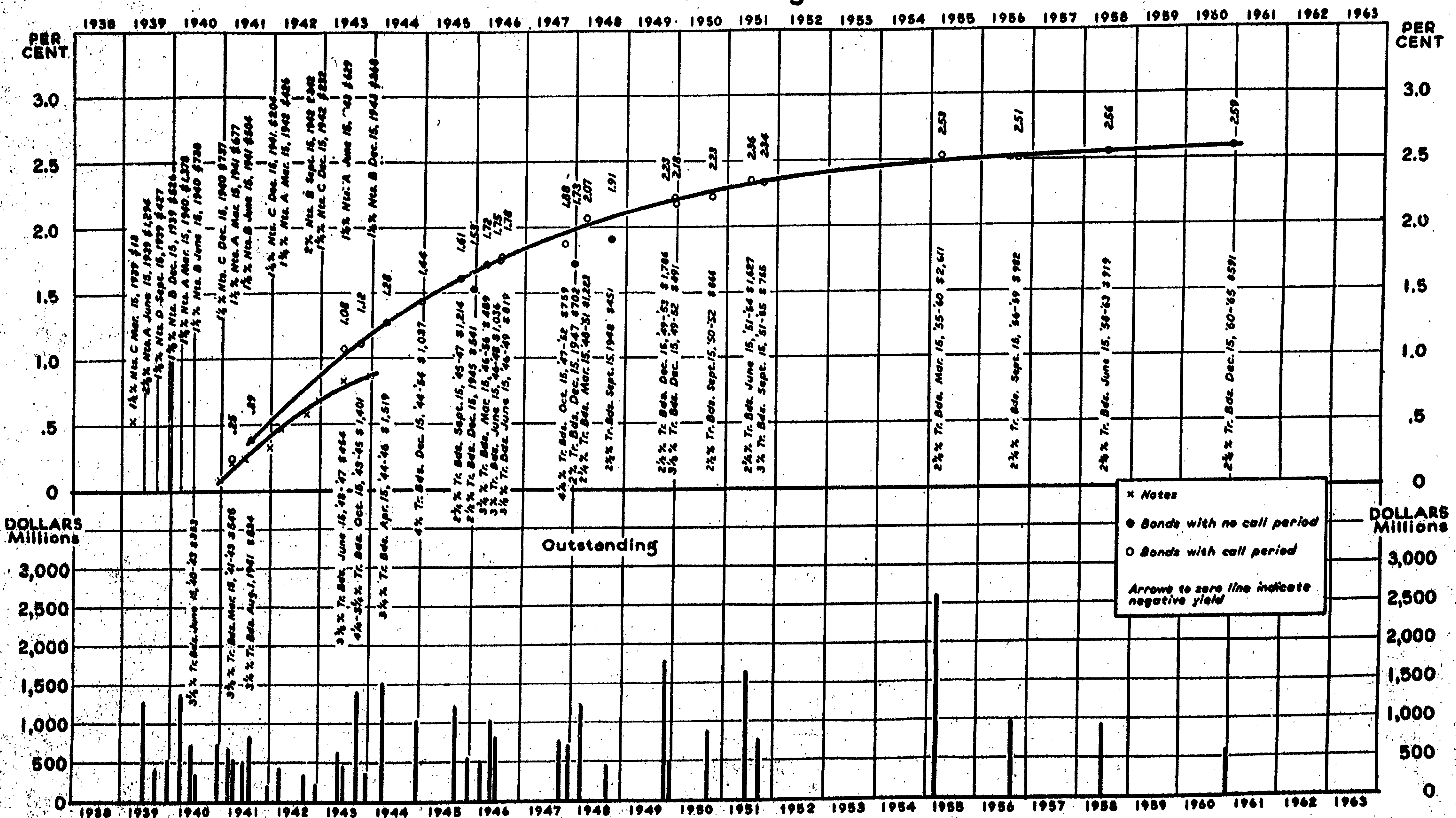
STATEMENT OF DR. AL F. O'DONNELL, ASSISTANT DIRECTOR OF RESEARCH AND STATISTICS, TREASURY DEPARTMENT

Mr. O'DONNELL. In my testimony before this committee on January 18, 1939, I presented a somewhat detailed explanation of the estimates which Mr. Hanes had previously introduced. You will remember that these estimates were presented as a range of the increase in income-tax receipts which the Federal Government might expect to receive in years following a complete refunding of all tax-exempt governmental securities now outstanding, assuming that no future governmental issues of securities would contain the tax-exempt privilege.

Since that time Dr. Harley L. Lutz, professor of public finance at Princeton University, has appeared before this committee and has presented other revenue estimates on this subject. His estimate of the ultimate effect on the Federal income-tax revenues was presented in terms of a single figure of $230,000,000 of increase, as originally calculated by Dr. Lutz which falls within the range of the comparable Treasury estimates of from $179,000,000 to $337,000,000, depending on varying assumptions.

YIELDS OF TREASURY BONDS AND NOTES JAN. 3, 1939

Based on Closing Prices



Note: For callable bonds, yields are computed to, and issues plotted as of, the earliest call date if the bond is selling above par and as of the final maturity date if the bond is selling below par. The smooth curves are fitted by eye.

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As contrasted with the single figure which Dr. Lutz presented, the Treasury estimates are submitted in terms of a range in order to take into account varying possibilities with respect to the level of business activity, the interest differential in any given year, the return on capital shifted from governmental securities to other investments, and the percentage of governmental holdings which individuals in high income tax brackets transfer to private investments when the interest is made taxable.

Not only does Dr. Lutz come within the range of estimates submitted by the Treasury as to the total tax to be received by the Federal Government, but he is also within our range on each of the two principal components of that estimate. Thus with respect to the Federal income tax to be derived from taxing interest received from future issues of State, local, and territorial obligations, Dr. Lutz gives a figure of $121,000,000 as compared with the Treasury's range of from $107,000,000 to $198,000,000. With respect to the Federal income tax to be received from taxing interest received from obligations of the Federal Government, its agencies and instrumentalities, Dr. Lutz's estimate of $109,000,000 compares with the Treasury's range of from $72,000,000 to $139,000,000.

Although Dr. Lutz's estimate falls within our range, his figures are lower than they would have been had he taken into consideration one factor which we consider to be fundamental, namely, the shifting of investments. Since Dr. Lutz did not allow for any effect of shifts from governmental securities to other investments, we can best make a comparable comparison of his estimates with those of the Treasury by eliminating from the Treasury estimates the effect of such shifts.

I take it from his remarks this morning, that this is the type of comparison in which Senator Austin is interested.

On this basis, Dr. Lutz's estimate, as it stands, of $230,000,000 increase in the Federal income-tax revenues, which will ultimately be realized by assuming the elimination of tax exemption from future issues of all governmental securities, falls almost exactly on the higher limit of the comparable Treasury estimate which ranges from $167,000,000 to $231,000,000. If he had included the effects of shifting, his estimates would have been larger and would thus have influenced his entire argument as to the over-all effect of the program.

Throughout the report which Dr. Lutz presented to this committee, he stated that if we taxed the interest from securities now exempt, individuals with large incomes would no longer continue to hold them, and, therefore, we would not receive the revenues which it has been estimated that the Federal Government would receive. However, he does contend that unless we can prove that individuals with high incomes continue to hold governmental securities, we are overestimating the anticipated revenue.

Surely, it is reasonable to assume that even though such persons do sell the governmental securities when they become taxable, the money received from the sale of these securities will be invested in other securities, the income from which will be taxable. I submit to you, therefore, that any estimate of the increased income-tax revenue to the Federal Government as a result of this legislation has completely missed a vital point of the analysis if it does not include the revenues which the Federal Government will receive from taxing the income on capital formerly invested in tax-free bonds but diverted by this legislation to other investments.

The CHAIRMAN. You think that is a very important factor?

Mr. O'DONNELL. Very important, indeed. The estimates which Dr. Lutz introduced do not attribute to this legislation sufficient increase in revenue. He would have us believe that the only increase in revenues attributable to this legislation is the revenue which we would get from taxing the interest received from governmental securities after they become taxable. His procedure ignores the fact that the legislation would cause some taxpayers with large incomes to shift from such investments in governmental securities when the interest becomes taxable and includes in the estimates of revenue only the income-tax receipts from such interest instead of the income tax received from the taxpayer of large incomes from the new investments into which the former large income holders of governmental securities shifted.

We are certain that such a shift will take place, but we do not know what percentage of the high income tax bracket holdings will be shifted, nor do we know what the rate of return will be on the capital after it has been placed in other investments. That is one of the reasons why we have submitted our estimates in terms of a range, so as to reflect rather wide assumptions on these points.

Dr. Lutz, however, in his estimates, adopts the narrower concept that the additional revenue received by the Federal Government, as a result of this legislation, is simply the revenue from the tax on the interest from the governmental securities themselves.

Because one of the fundamental purposes of this legislation is to provide greater tax equity, we feel it unreal to ignore the important source of revenue which must be attributed to the proposed legislation as a result of the elimination of the tax-free haven for some individuals in the high-income brackets.

The other principal causes of difference between the Treasury estimates and those of Dr. Lutz reside in unlike assumptions made with respect to—

(*a*) The amount of holdings of governmental securities allocable to individuals with net incomes of $5,000 and over;

(*b*) The allocation of such holdings to particular income-tax brackets;

(*c*) The differential measuring the value of tax exemption; and

(*d*) The use of current refunding rates versus existing coupon rates for determining the interest received.

The first of these differences between the estimates of Dr. Lutz and those of the Treasury is in the allocation of the tax-exempt security holdings to individuals in accordance with the size of their respective net incomes.

The CHAIRMAN. Would you stop a moment?

Your use there of the word "refunding" reminds me of a matter that I had, for the moment, overlooked. I understand that the Under Secretary of the Treasury desires to submit a memorandum upon that proposition that I raised this morning relative to refunding bonds, and that the Treasury Department has not had time to prepare that memorandum, and it wants a day or so in which to do so, and he will file that with us, and that will be made a part of the record.

Mr. O'DONNELL. As several different previous witnesses who have appeared before your committee have pointed out, we have relatively good information as to the holdings of investors other than individuals in governmental securities. In each of our estimates, as in the estimates of Dr. Lutz, the balance of the holdings of these tax-exempt securities, otherwise unaccounted for, is allocated to individuals.

It is my judgment, however, that he has allocated far too great a proportion of the unaccounted-for holdings, and, therefore, interest received, to individuals with net incomes of $5,000 and over.

In the case of his estimate of revenue which the Federal Government would receive from taxing the interest on State, local, and territorial obligations, while we believe Dr. Lutz's allocation of holdings to the group with net incomes of $5,000 and over to be excessive, it is not nearly so serious in its effect on the revenues as is his similar allocation in the case of the holdings of the obligations of the Federal Government, its agencies, and instrumentalities, because of the large amount of partially tax-exempt Federal securities which he thus allocates.

As Dr. Lutz stated before your committee, he used a Treasury publication, entitled "Securities Exempt From the Federal Income Tax as of June 30, 1937," to determine who holds the Government debt, by classes of holders. That publication did not classify the interest received by type of holdings, but it does show the original sources which assist in an analysis much more precise than the method employed by Dr. Lutz, who makes no attempt to determine the relative holdings of the various types of Federal securities by corporations and individuals.

In making its estimates, the Treasury analyzed the holdings of Federal debt, not only by type of holder, but also by type of security, classified as to whether or not it was wholly or partially tax-exempt.

That record of the Treasury analysis has already been introduced in evidence, as table III, page 14, of the record.

The CHAIRMAN. The printed record?

Mr. O'DONNELL. Yes, sir.

As a result of this analysis, we concluded that there was no reasonable probability that individuals with net incomes of $5,000 and over held the unaccounted-for partially tax-exempt securities in proportion to their reported holdings of this type of security.

With regard to Treasury bonds and United States savings bonds, it must be remembered that it is only the interest on principal amounts of $5,000 or less which is exempt from the surtax. Therefore, the incentive to individuals with net incomes of $5,000 and over for holding these partially tax-exempt Federal securities in principal amounts greater than $5,000 must come from other than tax reasons.

There is no reasonable probability that there is proportionate underreporting by individuals of the partially tax-exempt interest on which there is a liability for surtax. Of course we realize that United States savings bonds might be held in principal amounts of over $5,000 and yet the interest not be reported where the individual files his tax return on a cash instead of on an accrual basis. However, such interest on amounts in excess of $5,000 will be subject to surtax when realized.

After careful consideration of these and other data, such as the distribution of wholly tax-exempt interest by net income classes, we concluded that individuals with net incomes of $5,000 and over most probably held $1,000,000,000 of partially tax-exempt securities in addition to the $1,460,000,000 par value of these partially tax-exempt securities, the interest on which is now subject to surtax.

Thus, our total holdings of Federal securities by individuals with net incomes of $5,000 and over was $5,454,000,000, as contrasted with our estimate of Dr. Lutz's allocation of $9,591,000,000 in these brackets.

The balance of otherwise unaccounted-for holdings was allocated by the Treasury to individuals in the brackets with net incomes of less than $5,000.

Naturally, such an assignment as Dr. Lutz has made increases greatly the estimates of Federal revenues which the Government might expect to receive from the taxation of the interest received by these individuals.

While this allocation process is one on which there may be some difference of opinion, the Treasury feels that its procedure is the more valid.

The next step in making our revenue estimates, after the allocation of a certain amount of these unaccounted-for holdings of tax-exempt securities to the group of individuals with net incomes of $5,000 and over, is to distribute these holdings among the various net-income brackets. Of course, the higher the income-tax brackets among which these securities are allocated, the higher the rate of tax which the Federal Government will receive on the interest paid on the securities.

If there were no tax-exempt feature, and each individual continued to hold governmental securities, the Federal Government would collect income tax on the interest from these securities at the highest rate of tax to which the individual is subject after including this interest, since this income would be superimposed upon his other income.

In the Statistics of Income, an official publication of the United States Treasury Department compiled from tax returns, there is a table which shows, for individuals with net incomes of $5,000 and over, the amount of and the interest received from wholly or partially tax-exempt Government obligations, by net income classes and by each type of obligation, the amount owned, and the interest received. From this table Dr. Lutz could have taken a distribution by net income classes of the interest received or accrued on various types of governmental obligations during the year by individuals in the various net-income brackets as reported in their income-tax returns to the Treasury Department.

While we know, in the case of wholly tax-exempt securities, that the individuals report for information purposes only, nevertheless, we have no facts which would lead us to believe that underreporting is more prevalent on the part of any particular class of individuals.

Instead of using these known data to arrive at the effective rate of tax on the interest received by the individuals in net income brackets of $5,000 and over, Dr. Lutz utilized some very indirect methods to arrive at the effective rate which he used.

Neither of his indirect methods seems to me to have nearly the validity of the method used by the Treasury.

In one instance, he studied the distribution of holdings of partially tax-exempt securities, as reported in Statistics of Income and assumed that wholly tax-exempt securities would be held in corresponding fashion.

We have already pointed out that the interest from these partially tax-exempt securities is taxable if the individual holds more than $5,000 principal amount, and, therefore, these securities are not held in so large quantities, by people with large incomes, as are the wholly exempt securities.

This analysis bears out our contention that Dr. Lutz has assigned too large a proportion of the unaccounted-for securities to the brackets above $5,000.

His second technique of arriving at the distribution of interest of governmental securities in the brackets above $5,000 involved an examination of the corporate bond holdings reported in estate-tax returns for a period of 10 years. This procedure involves certain arbitrary methods of approximating interest received from the corporate bond holdings and the conversion of estate size classes to net income classes.

His final tax estimate is arrived at by averaging the tax computations based on each of these two methods of distribution, which gives an average tax rate of 25 percent as compared with the range of tax rates used in the Treasury estimates of from 35 percent in a year of low income to 38 percent in a year of relatively high income.

In using this rate for his revenue estimates, he is inconsistent, since on page 110 in his own report, for the purpose of determining interest cost differential, he states:

> 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.

There are other minor questions in approach to the whole problem, which, although they tend to increase Dr. Lutz's estimates as contrasted to the Treasury estimates, are matters on which there may be a reasonable difference of opinion. It seemed reasonable to us that we should adopt the reality of the current yield on the outstanding securities as being a fair concept of the refunding cost of those securities.

Dr. Lutz took the existing coupon rate, which is considerably higher than the current refunding rate, which procedure tends to give him somewhat larger revenues.

That is the point which Senator Byrd raised this morning.

Dr. Lutz recognizes in his general discussion that when the tax-exempt feature is removed from governmental securities, the securities will have to carry a higher rate of interest. In making our revenue estimates, we recognized that there might be a difference of opinion as to the interest differential which would have to be added to the present tax-exempt rate in order to make different types of taxable governmental securities salable under different conditions. The Treasury takes a probable range of differential cost into consideration in its estimates.

Dr. Lutz, however, is inconsistent in his treatment. In computing what the Federal Government would receive from taxing the future issues of State securities, he adds 0.6 percent to the coupon rate of interest.

However, in estimating the increase in the Federal Government's income-tax receipts resulting from the elimination of the tax-exemption feature from future issues of the obligations of the Federal Government, he does not allow for any tax on the increase in interest cost to the Federal Government. This, of course, tends to decrease the revenue estimates which he would otherwise have obtained.

The Treasury did not prepare estimates on any basis other than that there would be reciprocal taxation by the Federal Government and by the States of the interest from all outstanding governmental debt.

Dr. Lutz, however, estimates that the amount of $121,000,000 will be received from the Federal taxation of the interest of State, local, and territorial obligations, irrespective of the existence or nonexistence of tax-exempt Federal securities. I should like to submit to you gentlemen that it is highly probable that if the Federal Government were to tax the interest from State and local securities without subjecting the interest from Federal Government securities to reciprocal taxation and to complete Federal taxation, individuals to whom the tax-exempt privilege is of paramount importance would shift some portion of their holdings of State and local securities into holdings of tax-exempt Federal securities.

Dr. Lutz made no allowance for any such shifting under his option I relating to Federal taxation of the interest from State and local securities only, and, to the extent that such shifting would have taken place, under such conditions his estimate overstates the probable Federal revenues.

We fully recognize that there is an almost infinite combination of assumptions on the basis of which these revenue estimates might have been prepared.

The CHAIRMAN. Would you mind going back to the last paragraph on page 9? I think you stated what the fact was, but what do you assume the States which do not have income-tax laws would do in that regard?

Mr. O'DONNELL. We are not here making an estimate of revenue which the States might receive from income tax which they now have or might impose in the future.

We are concerned at this point with the amount of income-tax revenue which the Federal Government would receive by the taxation of the interest from State and local securities.

Now, as I have pointed out, Dr. Lutz issued the same figure for the two estimates purporting to cover two totally different situations.

We do feel, however, that the range of estimates submitted to this committee by the Treasury covers the most reasonable range of assumptions.

A common assumption used by Dr. Lutz and by the Treasury was to base the computations on what would happen in some future year, assuming that all existing debt had matured and had been refunded by securities which did not contain the tax-exempt privilege.

This concept is helpful for comparative purposes, as it allows us to deal with the existing volume of debt, rather than an estimate of the volume of debt 40 or 50 years hence.

Of course, if the volume of debt at that time were less than the present volume, the Federal Government would receive additional revenues, even though the tax-exempt privilege were not removed from Government bonds, because some of the money now invested in government securities which are not refunded would be put into other investments, any income from which would be subject to the Federal income tax.

One final point should be made. These estimates do not purport to be estimates of increases in the Federal revenues in the immediate future. The bill under consideration does not propose to tax retroactively any outstanding securities. Therefore, in the early years following the enactment of the new law, only a very small but indeterminate amount of increased income-tax revenue would be received by the Federal Government as a result of this proposed legislation. As the volume of tax-exempt securities diminishes, there will be an increased concentration of the remaining outstanding tax-exempt securities in the hands of those to whom the tax-exempt privilege is of the most value. Consequently, we have made no attempt to present estimates for any period of time until after all of the outstanding governmental securities have been refunded with taxable securities.

The CHAIRMAN. Thank you, Dr. O'Donnell.

The CHAIRMAN. Are you ready, Mr. Morris?

Mr. MORRIS. Yes, sir.

STATEMENT OF HON. JAMES W. MORRIS, ASSISTANT ATTORNEY GENERAL

Mr. MORRIS. Mr. Chairman, I was going to express regret that the Senators who listened so attentively to the gentlemen in opposition to this matter from a legal standpoint would not have the benefit of asking questions which they might feel would throw some light on the matter.

Now, I shall, however, undertake to make this statement in the nature of a reply to the testimony offered at the hearings of February the 10th and 11th, and to the brief submitted by the attorneys general of some 39 States and some 5 other officials, entitled The Constitutional Immunity of State and Municipal Securities, which we will refer to as the Yellow Book, in as much as they felt it convenient to refer to the study made by the Department of Justice as the White Book.

I shall undertake, Mr. Chairman, to be more restrained and more accurate in such statements as I have to make than is apparent from a reading of the testimony and of the book in question, and, in that connection may I say that, in as much as there has been reference made to the bias and political attitude of certain witnesses who have testified in this matter, I have undertaken to approach this problem as a matter worthy of study and thought, and I cannot see how it can be considered as a partisan issue. One Democratic President and three Republican Presidents and the Secretaries of the Treasury since 1920, have had the matter of the elimination of reciprocal immunity, as we know it and speak of it today, under consideration, and all have urged that such immunity be eliminated in one way or another. So, the effort cannot be said to be a partisan attack upon the States and their subdivisions.

I will undertake, first, to point out certain points with reference to which the Yellow Book takes violent issue with propositions which we have never advanced; second, to reply to the Yellow Book's criticism in its discussion of the immunity rule in the White Book; and third, to reply to the criticism of the latter's discussion of the sixteenth amendment.

Finally, I wish to mention the position adopted by the Government in two salary tax cases now pending before the Supreme Court, and concerning which I think this committee should be informed.

First, as to the straw men so vigorously attacked by the Yellow Book: Several of its sections—pages 20 to 38—and much of the early testimony, are devoted to demonstrating that the States, in the exercise of their reserved powers, are sovereign, and that it is as important today as in 1789 that the States remain as our local governments. The Yellow Book implies, but does not expressly state, that the Department of Justice has a different view. However, the adversaries who are belabored in its pages seem to be only Fortune Magazine, Aldous Huxley, Westbrook Pegler, and an unidentified writer in the New York Times Magazine.

It may be well to state that we are in the most emphatic agreement, as to the nature and the importance of State governments.

A full chapter of the Yellow Book is directed to the importance of respecting Supreme Court decisions—pages 39 to 54. Again, it hardly could be thought that we advocate disrespect for the decisions of the Court; orderly government and respect for the highest tribunal unite to demonstrate that an issue once decided must ordinarily be accepted as settled.

On the other hand, the Yellow Book seems to agree with us on two propositions:

First, if experience shows a doctrine of the Supreme Court to be defective, it may appropriately be reexamined—page 47;

Second, the Court itself is the best judge of the respect to be paid its decisions—pages 40–41, 43–44, 45, 47–48, 51–52.

As to the first proposition, we have urged, and it is unnecessary here to repeat, that experience has shown the doctrine of tax immunity to be notoriously unsatisfactory so far as it extends to private persons immunity from a nondiscriminatory tax.

The White Book goes no further than has the Court itself in indicating that decisions of the Supreme Court are not immune from examination, and, if found unsatisfactory, that they may be overruled by that court. It is necessary only to mention, in the last two terms alone, *Erie Railroad Co.* v. *Tomkins* (304 U. S. 64), overruling *Swift* v. *Tyson* (16 Pet. 1), *Helvering* v. *Mountain Producers Corp.* (303 U. S. 376), overruling *Gillespie* v. *Oklahoma* (257 U. S. 501), and *Burnet* v. *Coronado Oil & Gas Co.* (285 U. S. 393); *West Coast Hotel Co.* v. *Parrish* (300 U. S. 379), overruling *Adkins* v. *Children's Hospital* (261 U. S. 525); and *United States* v. *Wood* (299 U. S. 123), overruling *Crawford* v. *United States* (212 U. S. 183).

The CHAIRMAN. I think it would be a great convenience to have the citations of these cases in the record.

Mr. MORRIS. I will supply the citations, following my statement, of every case mentioned. The only reason I did not include them in my statement was that I did not want to burden the committee with a reading of them.

The CHAIRMAN. I am interested in what Justice Brandeis said in one of the cases, and I would like to read that particular case.

Mr. MORRIS. I will supply the citations, Mr. Chairman.

(The citations are as follows:)

TABLE OF CASES

Adkins v. *Children's Hospital*, 261 U. S. 525.
Brushaber v. *Union Pac. R. R.*, 240 U. S. 1.
Burnet v. *A. T. Jergins Trust*, 288 U. S. 508.
Burnet v. *Coronado Oil & Gas Co.*, 285 U. S. 393.
Clark Distilling Co. v. *Western Maryland Ry. Co.*, 242 U. S. 311.
Collector v. *Day*, 11 Wall. 113.
Crawford v. *United States*, 212 U. S. 183.
Erie Railroad Co. v. *Tompkins*, 304 U. S. 64.
Evans v. *Gore*, 253 U. S. 245.
Flint v. *Stone Tracy Co.*, 220 U. S. 107.
Fox Film Corp. v. *Doyal*, 286 U. S. 123.
Gillespie v. *Oklahoma*, 257 U. S. 501.
Graves v. *New York ex rel. O'Keefe*, No. 478, October term, 1938.
Group No. 1 Oil Corp. v. *Bass*, 283 U. S. 279.
Helvering v. *Gerhardt*, 304 U. S. 405.
Helvering v. *Mountain Producers Corp.*, 303 U. S. 376.
Helvering v. *Therrell*, 303 U. S. 218.
Holmes v. *Jennison*, 14 Pet. 540.
Indian Territory Oil Co. v. *Board*, 288 U. S. 325.
James v. *Dravo Contracting Co.*, 302 U. S. 134.
McCulloch v. *Maryland*, 4 Wheat. 316.
Miller v. *Milwaukee*, 272 U. S. 713.
Morehead v. *N. Y. ex rel. Tipaldo*, 298 U. S. 587.
National Life Ins. Co. v. *United States*, 277 U. S. 508.
New York ex rel. Cohn v. *Graves*, 300 U. S. 308.
Oklahoma v. *Barnsdall Corp.*, 296 U. S. 521.
Pollock v. *Farmers Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601.
State Tax Commission v. *Van Cott*, No. 491, October Term, 1938.
Swift v. *Tyson*, 16 Pet. 1.
Trinityfarm Co. v. *Grosjean*, 291 U. S. 466.
United States v. *Bekins*, 304 U. S. 27.
United States v. *Wood*, 299 U. S. 123.
West Coast Hotel Co. v. *Parrish*, 300 U. S. 379.

Mr. MORRIS. A particularly apt reference, in this regard, is to the dissenting opinion of Mr. Justice Brandeis in *Burnet* v. *Coronado Oil & Gas Co.* (285 U. S. 393). In response to the majority opinion, which reaffirmed the immunity of Government lessees from taxation and largely relied upon the fact that the issue had already been decided in the *Gillespie case*, Mr. Justice Brandeis replied that the *Gillespie case* should be overruled.

He said:

* * * in cases involving the Federal Constitution, where correction through legislative action is practically impossible, this Court has often overruled its earlier decisions. The Court bows to the lessons of experience and the force of better reasoning, recognizing that the process of trial and error, so fruitful in the physical sciences, is appropriate also in the judicial function.

He then listed some 30 cases where the Court had overruled its earlier decisions. Six years later, precisely as Mr. Justice Brandeis urged, the Court overruled both the *Gillespie* and the *Coronado cases.*

Throughout the Yellow Book, and throughout the testimony of last week, there runs a thread of strong protest that the Department of Justice should urge that the revenues of States and municipalities should be subject to Federal taxation.

I hope that the committee gets the emphasis that I have just made, that the revenues of the States and municipalities should be subject to Federal taxation.

If the White Book had suggested any such proposition, there would have been more point to this criticism. The Department of Justice subscribes unhesitatingly to the doctrine that any tax imposed on the

State or municipality, in the exercise of an essential governmental function, is forbidden by the implications of the Constitution.

The CHAIRMAN. I think I tried to say so.

Mr. MORRIS. You did say so, and I was very grateful to the chairman for saying so.

The testimony of Mr. Wood sought to convict the Department of a veiled and sinister purpose because taxes of one form or another have been sought to be imposed with respect to activities which, if his information is correct, must be proprietary in nature.

By the same token, we could be convicted of a purpose to undermine State governments because we impose taxes with respect to State liquor dispensaries, State railroads, and football contests in State universities.

The distinction is obvious, and has long been settled, between activities which are necessary to the existence of State governments and those which are proprietary or nonessential. In taxing the latter, the Federal Government shows, of course, no predatory purpose to tax the governmental activities of States and municipalities.

These matters, then, are not in dispute, however vigorous may have been the attack of our adversaries.

Before taking up the matters which are actually in controversy, it might be well if I outlined, in the briefest form, the views which we have presented to the committee.

The law of tax immunity has been in a more or less constant state of flux since its beginning. *McCulloch* v. *Maryland* (4 Wheat. 316), and the cases which followed it, held Federal instrumentalities and private persons who dealt with the Federal Government immune from State taxation because article VI of the Constitution declared the laws of the United States to be the supreme law of the land. There was not, of course, considered to be a comparable limitation on the Federal taxing power, and the representation of the States in Congress made this unnecessary. But, in *Collector* v. *Day* (11 Wall. 113), decided in 1870, the Court found a similar limitation on the Federal taxing power. *Pollock* v. *Farmers Loan & Trust Co.* (157 U. S. 429; 158 U. S. 601), holding the interest on State bonds to be immune because the Court held a tax on income to be a tax on the source, pushed this limitation further.

I might interpolate that counsel took a different view of what the Court did say, and, with respect to that, I shall allude later.

The CHAIRMAN. It has been so long since the reading of the *McCulloch* v. *Maryland case* (4 Wheat. 316), and it is so important to our decision here because it is the foundation case, I want to know whether my recollection of the facts is right.

Mr. MORRIS. Let me just briefly refresh your memory on that. The facts in the case are these:

The Bank of the United States was established in 1816. Within 3 years, eight States enacted laws designed to penalize the bank or expel its branches from their territory.

The State of Maryland enacted legislation which provided that if any bank established a branch office in the State without State authority—obviously aimed at the Bank of the United States—it must issue notes only in specified denominations and only on stamped paper to be purchased at the prescribed rates from the Treasury of the Western Shore.

Alternatively, the branch banks could gain exemption from this requirement by the payment of twelve or fifteen thousand dollars a year.

In an action against the cashier, the State court rendered a judgment for the statutory penalties.

The CHAIRMAN. Therefore, we might say that the case was one in which the equities were very strongly with the Bank of the United States.

Mr. MORRIS. I think it is positively inconceivable that the case could have been decided other than it was.

Now, it is true that the Court, in its opinion, speaking through Chief Justice Marshall, did not pitch its action on the fact of the discriminatory nature of these taxes, but it is equally indisputable that there was a shocking discrimination.

And it is also true, Mr. Chairman and gentlemen of the committee, that in that same case the Supreme Court countenanced a tax by the State of Maryland on the land owned by that bank, and stated that the State of Maryland could lay upon the citizens of Maryland owning shares in that bank the same tax that it would lay upon other citizens.

The CHAIRMAN. But it is true, of course, they were concerned with power rather than discrimination.

Mr. MORRIS. There is no doubt about it, and, as Justice Holmes said in this decision, it was not a question of any degree, but a question of whether there was any power at all.

The CHAIRMAN. I have heard the phrase stated in law school—the famour phrase of Chief Justice Marshall. Was that stated in that case?

Mr. MORRIS. Yes, sir. Webster was accredited with the use of that phrase in his argument, and it was adopted by Chief Justice Marshall. It is:

The power to tax involves the power to destroy.

Since the earlier decisions the Court has been largely engaged in restricting the boundaries indicated by those decisions. With particular respect to the *Pollock case*, we have shown that its authority has been substantially impaired by subsequent decisions. If the contractor, the lessee, and the employee of the Government is taxable, it is difficult to see why the bondholder should be exempt. The implications of the *Pollock case* have not been carried into the related fields of transfers of Government bonds or State taxation of bonds of another State. The prohibition against a Federal tax on exports and against State taxes on interstate commerce have not barred net income taxes, although these are express rather than implied prohibitions.

Let me interrupt myself to say: Of course, the answer has been made, and is made, that these taxes are in the nature of an excise, but, if the great implication of the Constitution is that no burden of taxation shall fall on those things, then it is difficult to see why, if the burden does fall with respect to one type of tax, it is not also to be prohibited with respect to the other.

The basis of the *Pollock case*, as measured by the opinion there, was that a tax on income is a tax on the source; this has expressly been rejected in *New York ex rel. Cohn* v. *Graves* (300 U. S. 308).

No other reason for immunity which has been advanced and which is still accepted by the Court will support the *Pollock case.* It is contradicted by the reasons the Court has advanced to deny immunity.

If the Congress were to enact the legislation recommended by the President, the question would relate to a nondiscriminatory tax on net income which included the interest on future issues of State and municipal bonds just as it included all other items of income. The essential fairness of the plan, and the absence of discrimination in it, would be graphically isslustrated by the corresponding waiver of the exemption of future issues of Federal bonds. It seems difficult to believe that, in the face of the recent decisions, the Court would now feel bound to follow the *Pollock case.*

Even if we are wrong as to the present rule of immunity, the legislation might well be sustained under the sixteenth amendment, giving power to tax income "from whatever source derived." The words of the Constitution must be construed to mean what they say, and, it would seem, there is no ambiguity whatever in this amendment.

The Supreme Court, it is true, ruled in *Evans* v. *Gore* (253 U. S. 245), that the amendment did not extend the taxing power of Congress; it construed the language in the light of external evidence. But if all, rather than a part, of this evidence is examined, the plain meaning of the language is confirmed and not contradicted.

May I say, for the information of Senator Byrd who has just come in, that what I have been doing here is simply, in a very brief manner, somewhat recapitulating the arguments which we submitted to this committee in our main statement, before undertaking to take up some of the matters asserted by the opponents of the measure.

The CHAIRMAN. I think that the facts we have been discussing are most important in the case.

Mr. MORRIS. I do, too.

The CHAIRMAN. Have they ever been presented to the Supreme Court in any case arising out of this controversy?

Mr. MORRIS. To my knowledge, they have not been fully urged.

The CHAIRMAN. Has there been any case where these facts might have been presented to the Court?

Mr. MORRIS. There might be a difference of opinion as to that.

The CHAIRMAN. Well, where they should have been presented.

Mr. MORRIS. If you take that view of *Evans* v. *Gore* (253 U. S. 245), which could have turned on the question of the meaning of diminution of salary during continuance in office.

The CHAIRMAN. I think that it did turn on that point.

Mr. MORRIS. They state such a tax was such a diminution as prohibited by article III.

Now, the argument was also made that, even if it were such a diminution as was prohibited by article III, the sixteenth amendment, overcame the limitation contained in article III.

It was evidently that argument that occasioned the Court to consider whether or not the sixteenth amendment did extend the taxing power beyond what it was prior to its enactment.

The CHAIRMAN. Being later in point of time?

Mr. MORRIS. Yes, sir.

But, Mr. Chairman, notwithstanding the fact that the sixteenth amendment deals with income from whatever source derived, and therefore may not have reached the question of judges salaries because article III is for the protection of the recipients, not the source—and we allude to that difference and we think it very important—Mr. Justice Holmes and Mr. Justice Brandeis, in their dissent, stated exactly the argument that the Department of Justice has presented to you, and, for that reason, felt that case should have been decided otherwise.

What I am trying to make clear is that it could very reasonably be said that the sixteenth amendment had the effect of taxing income "from whatever source derived," thus shutting out of view the immunity of a source from which income came, and, at the same time, not having the effect of overriding a previous constitutional provision which, in its terms and obvious purpose, was to protect, not the source of the income but the recipient of it. The provision in article III is not laid to prevent a tax on income from the Government; it is obvious that it is to prevent a burden from falling upon the recipient, namely, the judge, because it wishes to protect him from the decrease of salary.

I do not make this as an argument to support the *Evans* v. *Gore case* (253 U. S. 245); I only mean to point out the result could have been arrived at even though the sixteenth amendment had the feature or force of rendering taxable income from sources that theretofore had been immune.

The CHAIRMAN. But the history of the income-tax laws, of the Civil War period, the 1894 Act——

Mr. MORRIS (interposing). The first one——

The CHAIRMAN (continuing). Let me get my thought over to you. The history of the act, and the use of the phrase "from whatever source drived" was not presented to the Court in *Evans* v. *Gore* (253 U. S. 245), so far as the briefs show.

Mr. MORRIS. No; not so far as I know, and Mr. Cohen, I believe it was, made the statement that the counsel for Walter Evans had presented extensively the argument on this amendment and its meaning, and I have not found that this argument was presented.

The CHAIRMAN. Was that in the brief? Mr. Cohen is here.

Mr. COHEN. I did not say that, but, in a letter which I sent to you, I called your attention to the fact that Mr. Justice Van Devanter, who wrote the opinion, said counsel for the Government concedes, under our interpretation, there is no such argument to be made.

Am I not right about that?

Mr. MORRIS. You are correct, and it is a very critical point that there was no controversy between the Government and the taxpayer in that case as to the effect of this amendment.

The CHAIRMAN. I well remember Mr. Cohen's statement on that, since he reminds me of it, but I would like to get in my mind the situation clearly, and I would like to have you recapitulate those three acts and tell us what the exact language was in those three revenue acts, inclusive of the 1894 Act.

Mr. MORRIS. I think that I can do that, and I will ask my colleagues to correct me, if I make a mistake.

Now, the Civil War income tax, under which the case of *Collector* v. *Day* (11 Wall. 113) arose, the provision was as to income from certain enumerated sources that should be taxed—"and from any other source whatever." Am I correct about that?

Mr. GARDNER. That is precisely right.

The CHAIRMAN. That is the second from the last line on the bottom of page 96 of the White Book, being the act of 1861. "That tax was levied upon annual income 'derived from * * * (enumerated sources), or from any other source whatever.' "

Mr. MORRIS. Yes, sir; and that language, as I recall it, was followed through in the act of 1894, but, before we come to that, let me say this, that it is our thought, or we think that it is pertinent to the point you have raised, that, under the language of that act, the Court decided the constitutional power of the Congress to lay a tax on Judge Day.

The CHAIRMAN. In other words, the controversy in the *Day case* would not have occurred unless the Government had construed that language—"from any other source whatever"—to include the income from the salaries of State judges?

Mr. MORRIS. Precisely, and not only the Government, but the courts and parties all accepted that to be the meaning.

The CHAIRMAN. So, unquestionably, the Court must have construed that language to include the salaries of the State officials, otherwise there would not have been any case.

If the Court had not understood the language to be the intention of the Congress to lay that tax, they would not have reached the constitutional question of the power of the Congress to do that, and, to emphasize it, when the act of 1894 was being drafted, they recognized the decision in *Collector* v. *Day* (11 Wall. 113), using the same broad language, they felt the need to carve or they did carve out the exemption of salaries such as they thought had been announced and was announced in *Collector* v. *Day*, but they did not make an express exemption as to State or municipal bonds.

And, therefore, in the case of *Pollock* v. *Farmers Loan & Trust Company* (157 U. S. 429; 158 U. S. 601), precisely the same situation existed as had in the *Collector* v. *Day* case (11 Wall. 113).

Had the Court there not deemed the words "from any source whatever" to include the income from State and municipal bonds, they there would not have reached to the constitutional question as to the power of the Congress to lay that tax.

But, that is not all——

The CHAIRMAN. But I do not want you to get away from the acts. I want to clarify the acts. The act of 1862, also, had the same language; an income tax was imposed upon annual income "derived from" certain sources, "or from any source whatever."

Mr. MORRIS. I think that is the language that goes through it.

The CHAIRMAN. What act followed that?

Mr. MORRIS. There was one of '61, '62, '63, and '64, amended by '65.

The CHAIRMAN. The act of '64 included the same language as the act of '62?

Mr. MORRIS. Yes, sir. I do not think, Mr. Chairman, that there is any difference in that expression in these several acts. The act of '61 has been quoted on page 97 of our book, the language there being:

> An income tax was imposed upon annual income "derived from * * * (enumerated sources), or from any other source whatever, except as hereinafter mentioned."

Now, on page 98:

> The act of 1864 used the same language as the act of 1862—

which I read—

> The act of 1864 used the same language as the act of 1862, except that it extended the graduated feature of the tax by one step. The act of 1865 contained

the same language as above quoted from the act of 1862, but the additional step in graduation brought in by the act of 1864, was eliminated. The act of 1866 was amendatory of the existing law by specifying that the tax should apply to "the gains, profits, and income of every business, trade, or profession." The act of 1867 amended section 116 of the act of 1864 but the language above quoted was substantially retained.

The CHAIRMAN. Then there followed, in the act of 1864, the language almost exactly the same as the constitutional amendment—"or other gains and profit and income derived from any source whatever?"

Mr. MORRIS. Yes; that was in the act of 1864, then the act of 1870. It was to apply for the years 1870 and 1871.

The CHAIRMAN. I am not disputing you, but I think you are wrong.

Mr. MORRIS. I may be.

The CHAIRMAN. It does not make much difference.

Mr. MORRIS. Now, if I had the act of 1894—that act was, in form, similar to the earlier income-tax provisions. Section 28, in establishing the method of computing taxable gains, profits, and income, enumerated numerous specific sources, and—quoting—"all other gains, profits, and income derived from any source whatever."

The CHAIRMAN. What are you on now?

Mr. MORRIS. That is from page 101, about the seventh line from the bottom of the page. It is the last paragraph of that page.

The CHAIRMAN. "From any source whatever" is the language there?

Mr. MORRIS. Yes, sir.

The CHAIRMAN. And, of course, that was construed by the Court to include taxable income on State securities; otherwise, it would not have reached the constitutional question in the *Pollock case*?

Mr. MORRIS. Yes, sir. Now, when I say that, I mean explicitly construed, because, otherwise it would not have reached the constitutional question of power.

Now, there is a further step in that same chain of judicial acceptation, but, before I get to that, let me allude to something else.

In the debates in the Congress, there was an amendment introduced by Senator Hill to the act of 1894, wherein he said expressly excluded interest from State and municipal bonds, which amendment was rejected, and renewed, and rejected again.

The CHAIRMAN. Now, jumping down to the arguments in the Senate in 1910——

Mr. MORRIS. 1909.

The CHAIRMAN. Well, we will assume that all this occurred after the amendment had been submitted and when the matter was up; coming down to that time, I cannot find in the statements and papers where the line of thought we are now discussing was raised by anybody in the Senate.

Mr. MORRIS. It was not.

The CHAIRMAN. Senator Borah's speech does not contain any reference——

Mr. MORRIS. No, sir.

The CHAIRMAN. To the previous construction of the meaning of the phrase "from whatever source derived"?

Mr. MORRIS. No, sir.

The CHAIRMAN. I wanted to know if that was a fact.

Mr. MORRIS. But, let me say, since I have mentioned these two previous decisions, what I think is necessary and critical to the validity of the thought we are submitting that in the same Congress that proposed the sixteenth amendment substantially these same words were used in the taxing act of corporations. If you gentlemen have not studied that interesting relationship that exists between the proposal of the sixteenth amendment in that Congress and the adoption of the corporation excise tax of 1909, I submit that it is most illuminating.

In that Congress that did formulate and submit the sixteenth amendment, there was adopted the corporation excise tax of 1909, by the terms of which a tax was laid upon corporations, general stock companies and associations, equivalent to 1 percent upon the entire net income, over and above $5,000, received by it from "all sources" during each year.

Now, the validity of that tax with respect to State and municipal bonds, or, rather, the income from them, was challenged in *Flint* v. *Stone Tracy Company* (220 U. S. 107), and the Court there held—and that, I believe, was in 1911, before the complete ratification of the sixteenth amendment—that the words, "from all sources," included the interest from State and municipal bonds.

Now, we submit that where a phrase of substantially identical arrangment has had that judicial interpretation and consideration, it is not so ridiculously absurd and preposterous, as opponents would have you believe, to submit in all good faith that the words in the constitutional amendment, where it was competent to give the Government the power, had the meaning that repeated judicial cases and determinations had assumed them to mean.

I am not belittling the argument of the other side. There is a perfectly strong argument that they can and have made, but, to my mind, it weakens it tremendously when they must reach to the extremes of adjectival and adverbial condemnation to deal with what they have, but what are perfectly legitimate arguments to the contrary.

Senator AUSTIN. I came in late, and I want to inquire what the objective of this line of discussion is. Are you undertaking to demonstrate that such statutes as we are considering are free from doubt of constitutionality?

Mr. MORRIS. No, sir. I am trying to state the argument that can be reasonably and legitimately made to support such constitutionality, and I hope that the Senators will please understand our position.

It was alluded to by the gentlemen of the opposition, if we may call them that, that I was put upon the rack before the Committee on Ways and Means and faced with something or other to which I had to answer, and I think my answer, as quoted in the record, is such that in order that there may be no doubt as to my position, I should like for the record here to show what I did say.

Mr. REED. Will you answer this question: Do you personally entertain any doubt as to the constitutionality——

Senator AUSTIN. What are you reading from?

Mr. MORRIS. I am reading from the hearings before the Committee on Ways and Means, House of Representatives, Seventy-sixth Congress, first session, January 29, 1939," at page 42:

Mr. REED. Will you answer this question: Do you personally entertain any doubt as to the constitutionality of the proposal which is brought here?

To which I answered:

I do not think I would be candid if I said that the question was one without doubt.

Our objective, Senator, as stated elsewhere in this record, has been to try to gather the material of a legal and factual nature which might be considered as a part of the background of the constitutional amendment and helpful to Congress in the consideration of this problem.

It is not our business or our intention to express opinions as to the constitutionality of measures, and we are not doing so. We draw from that material arguments which we think are sound arguments which we think the Court could rest upon in sustaining the constitutionality of this measure.

Senator AUSTIN. Will you permit another question?

Mr. MORRIS. Yes, indeed, sir.

Senator AUSTIN. I thought I gathered from your brief that you were trying to get the Congress to enact the statutes, for one purpose, among others, namely, to give to the cause the presumption of constitutionality by the act of Congress. Do you take that position?

Mr. MORRIS. In the first place, I am not trying to persuade the Congress to do anything. I am trying to give you the benefit of our studies, to the end that you may draw the conclusions that you feel you should.

In the second place, I have stated, and I reiterate, that, if an act of this kind that is proposed be enacted, and the question came before the Court, where there is laid a tax applicable only in futuro and without retroactive burdens upon those who in good faith had no right to assume that they would be taxed, and, if that legislation had the further element which emphasizes its nondiscriminatory character, by extending to the States the right to tax like revenue from Federal sources as was by that act being taxed from State sources, that I believe the question would be one which would have a greater appeal to the Court, because it had a greater element of justice and fairness and nondiscriminatory characteristics to it.

Have I answered the Senator's question?

Senator AUSTIN. I think you did with one word, when you said "yes." I understood you to say "yes."

I must have misread your brief, if I had such a firm impression, as I do have, that one of the principal objectives is to induce the Congress to enact the legislation, notwithstanding the unconstitutionality, for the objective of giving to the legislation the presumption which is gained by the act of Congress.

Mr. MORRIS. I think, in all candor, since the Senator has that view in mind, I should explain what my view is.

There can be no question of doubt that an act of Congress ordinarily carries with it the presumption of constitutionality, and I assume that presumption is weighed in the determination by the Court as to its validity.

I think that the chairman of this committee, in respect to a statement that was made somewhat along the line of the Senator's question, amply deals with what the situation would be if this Congress passed this act, notwithstanding doubts as to its constitutionality, but for the purpose of having it reviewed and passed upon by the Supreme Court.

I think the record that there has been doubt on the part of Members who supported the legislation would seriously weigh with the Court, with respect to any strong presumption of constitutionality. I mean, if it was thought that it was passed in order to give an opportunity to pass on it, it probably would not carry the same weighty constitutional presumption which it might if those doubts were not expressed, but I do say the Court would not be misled on that, and, with respect to the second part of your question, I have said, and I reiterate, that in any field of a controversial character, where a question of constitutionality is the controversy, I doubt that it can be said by anyone to a certainty that any given legislation is constitutional.

In these circumstances, I do say, in my letter of transmittal of the so-called White Book to the Treasury Department, that I believe the arguments, being what they are, that even though the doubt might be greater, the Congress would be justified in taking such action as to enable the Court to determine the question of constitutionality; and I stated that very course had been taken and had implicitly been sanctioned by the Supreme Court in the *Evans* v. *Gore case* (253 U. S. 245), where the Court pointed out that Congressmen, who supported the measure, expressed grave constitutional doubt, but passed it so that the Court could determine its validity.

And, may I add to that this further thought, that when one undertakes to deny that opportunity of determination it is to run the risk that has been run when a great President of this country vetoed an act of Congress on the ground that it was unconstitutional, and which thereafter was passed over his veto and which thereafter was sustained by the Supreme Court as being constitutional, and that was no less a great jurist than President Taft. We have a rather strong precedent for action taken, even though there was uncertainty as to its constitutionality, when President Jefferson, who had well-known doubts as to the constitutional power to effect the Louisiana purchase, nevertheless did not permit such doubts to prevent that action.

My view only, Senator, is that it is for the Supreme Court to say with finality, when the exact question is before it, and I would not hazard an opinion or permit myself to suggest to the Senators what it is their duty to do. That is for them to determine, and certainly not my function to advise. I do say that where there is this controversy it is a question that can well be passed upon by the Supreme Court to determine, and it cannot be so determined unless you——

Senator AUSTIN. May I interrupt you there?

Mr. MORRIS. Yes.

Senator AUSTIN. Don't you think that the question can be determined in the cases now pending in the courts?

Mr. MORRIS. I do not see how.

Senator AUSTIN. Well is it not true that recently a petition was granted for certiorari in the Supreme Court in the case of *James F. Pickett* v. *United States* (No. 642) in which this question is involved?

Mr. MORRIS. I am not familiar with that case.

Senator AUSTIN. Just assume that the question has been raised and is pending in the Court, do you not think we would better perform the duties of our office to allow the Court to decide the question before we pass the statute with no such advice about it?

Mr. MORRIS. The present revenue law undertakes to exempt the interest from State and municipal bonds from taxation. I do not see how a tax could be asserted any more than I see how in the *Pollock case*, had it been clear that the words "from whatever source" did not include the interest from municipal bonds, the Court would have passed upon the constitutional question.

Senator AUSTIN. I think I had better correct an impression I gave. In the specification of errors I notice this, which I think points out the fact, that it deals with immunities of agencies of the State in the exercise of sovereign power.

Mr. MORRIS. Yes, we have several of those cases. We have a number of these, and the Government is continuing to explore the possibilities——

Senator MILLER. I have been called out. Now, see if I understand your contention on the question you are presenting to us, that the acts of 1861, 1862, and 1864, in the case of *Collector* v. *Day* (11 Wall. 113) it was shown contained a provision, "income from whatever source derived."

Mr. MORRIS. That was there, substantially.

Senator MILLER. That was in those statutes?

Mr. MORRIS. Yes—not exactly—it was, "From any source whatever." It was slightly different.

Senator MILLER. The real words were just "from any source whatever."

Mr. MORRIS. That is right.

Senator MILLER. Now the sixteenth amendment contains the words, "from whatever source derived."

Mr. MORRIS. Yes.

Senator MILLER. Now, the question in *Collector* v. *Day* (11 Wall. 113), was decided not on the question of the power of the Congress to levy the tax?

Mr. MORRIS. Oh, yes; it was.

Senator MILLER. But, it was decided on the immunity question, was it not?

Mr. MORRIS. That was the question——

Senator MILLER. I know. Of, course, I did not mean that. That is an unfortunate statement. What I meant was not on the question of whether or not it was included, but on the constitutional power of immunity.

Mr. MORRIS. Exactly.

Senator MILLER. Now, it is your contention, or the thought that you are presenting to us is this, that under the terms of the sixteenth amendment that a case arose, and there followed the doctrine, in *Collector* v. *Day* (11 Wall. 113), that it would be sustained as including just what the amendment says—"From whatever source derived."

Mr. MORRIS. In this regard only: The thought is that if, in the statutory language in *Collector* v. *Day* (11 Wall 113), the words, "from any other source whatever," were considered to include this kind of income, which it must have done, else the Court would not have reached the question of power, then, in the constitutional language, which clearly carries the power intended to be carried, that there should be included that type of income which was construed to be included in the statutory language in *Collector* v. *Day* (11 Wall. 113), and *Pollock* v. *Farmers Loan & Trust Company* (157 U. S. 429; 158 U. S. 601).

Senator MILLER. And then I understand your contention correctly?

Mr. MORRIS. Yes, sir.

Senator MILLER. And there has been no subsequent decisions that would indicate that the Court had departed from that, or would lay down any other rule than that which you have been advocating here? Is there, or not?

Mr. MORRIS. To answer that, the *Brushaber case*, and other cases, where the Court had occasion to make expression concerning the sixteenth amendment, are to the effect that it does not extend the taxing power to income "from whatever source derived;" but I am submitting this is an argument that I----

Senator MILLER. In those cases decided subsequent to the adoption of the sixteenth amendment, in which they limited or held this clause did not extend to and include those things, were they more or less limitations of the power granted or carried in the sixteenth amendment?

Mr. MORRIS. Well, I think that I had rather state it this way: That such expressions as there have been by the Supreme Court do not show any acceptance of the view that I have been submitting, and they do not show that this phase of the question has ever been pressed upon them for decision.

The CHAIRMAN. They have never considered the meaning of the language, "from whatever source derived"?

Mr. MORRIS. Unless it be the rather oblique consideration with reference to the question of apportionment.

Senator AUSTIN. I would like to get your view about the language in *Evans* v. *Gore* (Note 250, 253 U. S., 245):

> 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."

And then the Court continues:

> 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 was said in other cases.

The question is: Do you not think the Court did take this precise question that you are discussing in the *Gore case* and decide it?

Mr. MORRIS. I am sorry that the Senator was not in when we dealt with that very broad question, and it is this: The case of *Evans* v. *Gore* (253 U. S. 245) certainly stands for the proposition that the sixteenth amendment did not reach to further subjects of taxation. It says so.

The Senator will recall that in that opinion there was a dissenting opinion by Mr. Justice Holmes, in which Mr. Justice Brandeis concurred, in which they took the position that the sixteenth amendment means exactly what our argument to you asserts, have been intended to.

The case of *Evans* v. *Gore* (253 U. S. 245) turned on the question of diminution of the judge's salary, in violation of article III, so I pointed out there may be the basis for a distinction that, even though the sixteenth amendment did expose to taxation income from many sources, it did not have the effect of overriding the provision of article III which protected the judge, namely, the recipient of the income, from taxation, and was not intended to deal with the same question which the sixteenth amendment does.

Senator MILLER. Why would not the sixteenth amendment apply to article III of the Constitution? Of course, that was income.

Mr. MORRIS. I would never reach that question in that case, Senator, but I can still see that it might be said that the sixteenth amendment will do what I hope to have a chance to show you what I think it may well do—that is to eliminate consideration of source with respect to income, and yet leave intact from taxation income of the judge when he acquired office at a time when there was a constitutional immunity. I mean, I do not think that the questions are the same.

The Court said there that the sixteenth amendment did not override article III. I am saying that the Court may still say it did not, and yet give to it the effect that it did exclude from consideration source of income when it comes to the question of taxation of income.

The CHAIRMAN. I think that the point we are discussing is a most important one, and the only one that I see that gives justification for the Government's position.

It does not seem to me that there has been brought out here one fact that appeals to me, and that is in further discussion of the 1894 act, which contained the phrase "from any source whatever"— —

Mr. MORRIS. "From any source whatever."

The CHAIRMAN. Which was held by the Court in 1895 to include the income from municipal and State securities.

Mr. MORRIS. Yes.

The CHAIRMAN. And you have not said, and it seems to me important to call attention to the fact, that it was out of the *Pollock case* that the agitation for the sixteenth amendment arose. If the *Pollock case* had been decided differently there would have been no necessity for the sixteenth amendment. It seems to me that we must assume that the phrase, "from whatsoever source derived," when written into the sixteenth amendment came from that case.

Mr. MORRIS. Yes; it came from it.

The CHAIRMAN. And it seems amazing to me that there was no discussion in the Senate at that time of that fact; that the very statute out of which the controversy arose had something——

Mr. MORRIS. Exactly; and not only that, but the language, when enacted into that statute, had been——

The CHAIRMAN. I want to get my idea over.

Great emphasis was placed, in the Senate, on this argument upon the apportionment proposition.

Mr. MORRIS. Yes, sir.

The CHAIRMAN. But nothing seems to have been said about the identical language that we had in the 1894 statute, and the language that we have in the sixteenth amendment; to me, that is a vital factor.

I grant that the Senate of the United States may not have discussed that proposition, but it seems to me that fair-minded men must come to the general conclusion that the people of the country had some idea of what that phrase meant, and they were told by the Supreme Court that the phrase included the income from State and municipal securities.

Mr. MORRIS. They were told by the Supreme Court——

The CHAIRMAN. It seems to me that is the vital fact to be brought out in this argument. I do not mean that I necessarily agree with it, but I say that seems to be the vital factor in the presentation of the Government's case.

Mr. MORRIS. It is; and I shall try to deal with it.

But, please let me ask the chairman not to come to the view yet that this is the only vital factor, the only justification for the Government's position being sustained, because I think that it is important to view what our opponents say in their effort to demolish our position; because, if that view be taken, as would appear possible from some of the questions of the committee, then our position is very much less strong than we think it is.

But, on the point that you have just mentioned, here our argument comes to that. That is the argument which is drawn by the opponents when they say that it is inconceivable that there would have been passed through the Congress a resolution having the effect of destroying our form of government and doing away with the dualism that we had without there being debate on the subject.

Well, I think so, too, and I do not believe that such a thing could happen, and I do not believe that such a thing did happen. I think that the thought before the Congress was, as Mr. Justice Holmes said, that the problem of dealing with the cause that had led to the results in the *Pollock case*, and the cause that led to the results in the other cases, was looking to the source of income that was the subject of taxation.

A progressive income tax could not be laid on income from real property, because it had to be apportioned, and you cannot lay an income tax based on ability to pay, and uniform throughout the country, if it is apportioned. The difficulty was in looking at the source from which it came.

The same thing was said to be true concerning income from personal property. That, too, could not be laid without apportionment, and that, too, because you look at the source.

Do not forget that in the *Pollock case* there was the question of taxing income from municipal bonds—and you could not tax that income. Why? Because it came from a source which it was thought would be burdened if the income from it was taxed.

Now, the cause of that trouble was in not looking at income as something which a person, an individual or a corporation, could have without hooking up that income with the source from which it comes.

Our opponents say that the *Pollock case* did not mean that, while I say that the *Pollock case* itself should be looked at and it does say so.

Mr. MORRIS. The Yellow Book does not deny that every tax immunity opinion of the Supreme Court prior to *Collector* v. *Day* (11 Wall. 113), was placed squarely upon Federal supremacy. It seeks to escape this fact by two routes. The first charge is that the basis of decision in *McCulloch* v. *Maryland* (4 Wheat. 316), and the cases which followed it, was "a bold and intentional overstatement" (pp. 72, 73). But, "bold and intentional overstatement" or not, it remains the basis of decision. The attack on Marshall, it must be noted, comes strangely from those who cry for respect of Supreme Court decisions and who insist that statements of the Court must continue, without reexamination, in their original form throughout time. The second assertion, that "Federal supremacy" means supremacy of the Federal system (pp. 72, 75–76), is refuted by the Court's own language, expressly stating that immunity was extended because of article VI, which provides that the Federal laws should be the supreme law of the land. It seems worth while to read a few extracts to the committee from *McCulloch* v. *Maryland* (4 Wheat. 316):

> This great principle is, that the Constitution and the laws made in pursuance thereof are supreme; that they control the constitution and laws of the respective States, and cannot be controlled by them (p. 426).
>
> The question is, in truth, a question of supremacy; and if the right of the States to tax the means employed by the general Government be conceded, the declaration that the Constitution, and the laws made in pursuance thereof, shall be the supreme law of the land, is empty and unmeaning declamation (p. 433).
>
> It has also been insisted, that, as the power of taxation in the general and State

Governments is acknowledged to be concurrent, every argument which would sustain the right of the general Government to tax banks chartered by the States, will equally sustain the right of the States to tax banks chartered by the general Government.

But the two cases are not on the same reason. The people of all the States, have created the general Government, and have conferred upon it the general power of taxation. The people of all the States, and the States themselves, are represented in Congress, and, by their respresentatives, exercise this power. When they tax the chartered institutions of the States, they tax their constituents; and these taxes must be uniform. But, when a State taxes the operations of the Government of the United States, it acts upon institutions created, not by their own constituents, but by people over whom they claim no control. It acts upon the measures of a government created by others as well as themselves, for the benefit of others in common with themselves. The difference is that which always exists, and always must exist, between the action of the whole on a part, and the action of a part on the whole—between the laws of a government declared to be supreme, and those of a government which, when in opposition to those laws, is not supreme (pp. 435–436).

Having demolished this argument as to the State taxing power, Marshall then adds that, even if it were correct, it could serve only to limit the Federal power to tax State banks. In his words:

But if the full application of this argument could be admitted, it might bring into question the right of Congress to tax the State banks, and could not prove the right of States to tax the bank of the United States (p. 436).

This the Yellow Book seems to magnify into an alternative holding of the Court (p. 84).

2. The Yellow Book cites 33 cases as "clearly upholding reciprocal immunity" (pp. 59–62). We need not stop to analyze these decisions; it is sufficient to note that *Helvering* v. *Gerhardt* (304 U. S. 405) and *Helvering* v. *Therrell* (303 U. S. 218) are in this somewhat catholic list.

The prevading fallacy in the reasoning of the Yellow Book is well illustrated by this undiscriminating list of cases. It construes the White Book to deny any constitutional immunity of the States. This, of course, we do not deny. But the Yellow Book finds the discussion in the White Book to be contradicted by any opinion which recognizes the immunity of the States or of any of their instrumentalities. It then proceeds to assign that opinion to the list which affirms a "reciprocal" immunity.

The Yellow Book, it may not be amiss to note, takes sharp issue (pp. 89–93) with the White Book, and thus with the Supreme Court in *McCulloch* v. *Maryland* (4 Wheat. 316) and in *Helvering* v. *Gerhardt* (304 U. S. 405), so far as they point out that one of the reasons for the differences between the Federal and the State taxing powers is that the States are represented in Congress while the United States is not represented in the State legislatures. Solicitor General Epstein admitted in his testimony that there was language in the opinion in *Helvering* v. *Gerhardt* (304 U. S. 405) contrary to his position before the committee. It may be worth while to show the full extent of this language. In a footnote the Court said:

It follows that in considering the immunity of Federal instrumentalities from State taxation two factors may be of importance which are lacking in the case of a claimed immunity of State instrumentalities from Federal taxation. Since the acts of Congress within its constitutional power are supreme, the validity of State taxation of Federal instrumentalities must depend (*a*) on the power of Congress to create the instrumentality and (*b*) its intent to protect it from State taxation. Congress may curtail an immunity which might otherwise be implied, *Van Allen* v. *The Assessors* (3 Wall. 573), or enlarge it beyond the point where, Congress being silent, the Court would set its limits (pp. 411–412).

It continued, in the text:

> In sustaining the immunity from State taxation, the opinion of the Court, by Chief Justice Marshall, recognized a clear distinction between the extent of the power of a State to tax national banks and that of the National Government to tax State instrumentalities. He was careful to point out not only that the taxing power of the National Government is supreme, by reason of the constitutional grant, but that in laying a Federal tax on State instrumentalities the people of the States, acting through their representatives, are laying a tax on their own institutions and consequently are subject to political restraint which can be counted on to prevent abuse. State taxation of national instrumentalities is subject to no such restraint, for the people outside the State have no representatives who participate in the legislation; and in a real sense, as to them, the taxation is without representation. The exercise of the national taxing power is thus subject to a safeguard which does not operate when a State undertakes to tax a national instrumentality (p. 412).

The opinion later recurs to this thought:

> There are cogent reasons why any constitutional restriction upon the taxing power granted to Congress, so far as it can be properly raised by implication, should be narrowly limited. One, as was pointed out by Chief Justice Marshall in *McCulloch* v. *Maryland, supra* (pp. 435–436), and *Weston* v. *Charleston, supra* (pp. 465–466), is that the people of all the States have created the National Government and are represented in Congress. Through that representation they exercise the national taxing power. The very fact that when they are exercising it they are taxing themselves, serves to guard against its abuse through the possibility of resort to the usual processes of political action which provides a readier and more adaptable means than any which courts can afford, for securing accommodation of the competing demands for national revenue, on the one hand, and for reasonable scope for the independence of State action, on the other (p. 416).
> * * * Once impaired by the recognition of a State immunity found to be excessive, restoration of that power is not likely to be secured through the action of State legislatures; for they are without the inducements to act which have often persuaded Congress to waive immunities thought to be excessive (p. 417).

Mr. Epstein urges, however, that this opinion is not sound constitutional law. We are gratified to note his agreement with our position that the Constitution is not frozen in perpetuity by a decision of the Supreme Court. We wish, however, to point out that he takes issue with the latest decision of the Court while we attack an older decision, the reasons of which have since been departed from, and which is contradicted by the subsequent decisions in analagous fields.

In the brief of the United States, amicus curiae, to be filed today in *Graves* v. *New York ex rel. O'Keefe*, No. 478, October term, 1938, the Department of Justice urges at some length (pp. 21–36) that the Court has consistently acted on the assumption that the scope of the Federal and the State taxing power is not precisely "reciprocal." We have doubt as to the necessity, and perhaps of the propriety, of repeating that argument here. It will be sufficient, we believe, if copies of that brief are filed with the committee.

The White Book takes the position that the basis of the decision in *Pollock* v. *Farmers Loan and Trust Company* (157 U. S. 429; 158 U. S. 601) was that a tax on the income of Government bonds was a tax on the source, and that this doctrine has subsequently been rejected. The Yellow Book agrees that the proposition is no longer good law, but says that it was not the basis of decision of the *Pollock case* (pp. 158–162). For this it relies, not upon the *Pollock case* but upon the distinctions of that case which were adopted in the decisions rejecting the doctrine that a tax on the income is a tax on the source. But the majority of five Justices in the *Second Pollock case* opinion plainly said, "as to the interest on municipal bonds, that could not be taxed because of a want of power to tax the source." At a later point in this same opinion the Court repeated this explanation of the decision: "The revenue derived from municipal bonds cannot be taxed because the source cannot be." It may also be noted that Mr. Wood, in his testimony against the White Book, seems to have agreed with this interpretation of the Pollock decision.

The question before the Congress in determining what kind of a resolution it wanted to deal with this question that had been raised by the *Pollock case*, which the chairman correctly says was the reason for the sixteenth amendment, recognized that it was a question of source. They did not want an income tax that had to be determined by what source it came from. So, when they cut off "looking to the source" to determine the taxability of the income they were not dealing with a question that threatened to destroy the Federal system.

I hazard the proposition right here, and I certainly want to state it broadly, that no discriminatory tax could be laid that would do violence or injury to a State government or its municipalities no more than could, under any circumstances, the State discriminate against the Federal Government.

There you have got something that would go to the destruction of your dual system and would certainly receive debate before action was taken, unless it was pitched out without any debate at all.

But they put their reliance on the proposition that the meaning of these words was not adopted because it means the destruction of the government. If given the meaning that seems to be the natural result of what was held on the *Pollock case*, it could not have that destructive application as it was only a question of source.

Now, I do not want to burden this argument or statement with too much criticism, certainly not in the way of captious criticism of the extravagant things that were said by opponents, although I would like to call attention to some things.

Senator AUSTIN. Before you leave that, we are not to draw from your argument, are we, that you claim that the *Pollock case* did not hold that a Federal tax on State and municipal bonds was invalid for want of constitutional power to tax the States?

Mr. MORRIS. I intended to say it did that.

Senator AUSTIN. In the next place, it also held, did it not, as to all other taxes it made the source of income the vital criterion of validity?

Mr. MORRIS. I think it made it as to all income.

Senator AUSTIN. I did not understand that.

Mr. MORRIS. I say I think it made the source the criterion of all income they were there considering.

Senator AUSTIN. You cannot divorce these words we are tyring to interpret, that is to say, leave them out; they have to be considered in connection with the context.

Mr. MORRIS. Absolutely; no part should be lifted out of the context. I do not think, as opponents have said, you have the right to leave the word "power" out of it. If our contention as to what the amendment means is the right one, it follows from the fundamental canon of constitutional construction, that there must be given meaning to every word in the constitution.

The only way they can base their argument here is to say that "power" means nothing. That it was no new grant of power. "Whatever source derived" has no meaning because it is repeatedly stated that it has the same meaning without those words. Now, that is not, the way most of us have been taught, the canon of construction applicable to the Constitution.

All I say, Senator, is that at least our view is not so absurdly preposterous and ridiculous as has been intimated, and that it does have the sanction of very respectable authority.

Now, turning for the moment from the discussion of the sixteenth amendment and getting to the point that the chairman asked some question about the other day.

The Yellow Book insists (pp. 138–157) that the decisions in analogous fields are, in truth, wholly consistent with the Pollock decision. This insistence is, in large part, based on the fact that the Court in each of these fields has recognized or distinguished the Pollock decision.

The White Book, of course, did not suggest the contrary. Had the Court not distinguished the *Pollock case*, it would be not only inconsistent with these later cases but already overruled sub silentio. This, indeed, was the view of the status of the *Pollock case* expressed by the minority justices in *Janes* v. *Dravo Contracting Company* (302 U. S. 134). There Mr. Justice Roberts, writing for himself and Justices McReynolds, Sutherland, and Butler, said:

> The judgment seems to me to overrule, sub silentio, a century of precedents and to leave the application of the rule uncertain and unpredictable (p. 161).

Senator AUSTIN. They were protesting against it.

Mr. MORRIS. Exactly. They were against the decision in the *Dravo case*, but, be that as it may, the Justices are not unadvised of what the meaning of the Court's decision is, although they may not agree. It seems idle to describe as ridiculous and absurd the thought that they were right in their view of what the Court did, even though it is not what they would have done.

Thus, four members of the Court gave it as their deliberate opinion that the *Pollock case* had already been overruled. We do not go nearly so far but merely insist that it is inconsistent with later decisions. Yet the Yellow Book, with characteristic immoderation, "deplores the use of such a technique," and describes our argument as "absurd," "long discarded," and suggestive of "desperation."

To return to the basic position of the Yellow Book, that the *Pollock case* is reaffirmed every time it is recognized and cited as an existing rule, I believe the committee will find this to be the truly critical point of difference between the White Book and our opponents.

The witnesses who have appeared before the committee have reiterated that the *Pollock case* has consistently been followed, and that no majority opinion has suggested that it is no longer good law. Upon this simple proposition our opponents pitch their entire argument for its continued validity.

We have never suggested that the *Pollock case* has already been overruled. We do say that it reached a result which was unsound, that the subsequent decisions in analogous fields are inconsistent with it, that the reason advanced for the decision has been rejected in subsequent cases, and that it is supported by no other reason which has been advanced for tax immunity and which is now accepted by the Court. For these reasons we think the Congress might well take action which would permit the Court to reexamine the question. But, until that is done, the *Pollock case*, of course, remains as the rule of the Court. Other opinions will, of course, recognize that the Court has so ruled. Subsequent decisions will, of course, say that while bond interest may not be taxed, the contractors' receipts, for example are taxable. The whole case of our opponents, in short, comes down to the fact that the Court has never taken the unheard of step of overruling a prior decision in obiter dictum.

Let me call to the attention of this committee something rather illuminating on this point. It will be recalled that the Supreme Court decided the *Adkins case* in 1922 or 1923, holding invalid the minimum-wage law.

It was in 1936, I think, that a minimum-wage law came before the Court in the *Tipaldo case.* They sought to distinguish the New York law from the one in the *Adkins case.* The Court held that they could not be distinguished, and, therefore, on the strength of the *Adkins case,* struck down the law involved in the *Tipaldo case* as unconstitutional.

Within a year, the question was before the Supreme Court in the *West Coast Hotel Company case,* involving a minimum-wage law from Washington. There the Court upheld the constitutionality of the minimum-wage law and let us see why.

They said that in the *Tipaldo case* the Court had not been asked to reexamine the *Adkins case.* Therefore, the validity of the *Adkins case* rule was not open to question.

Mind you, it was on the strength that it was indistinguishable from the *Adkins case* that the law fell.

But, in the *West Coast Hotel Company case,* which was directly in point, the Court held that they had been asked to reexamine the validity of the *Adkins case;* they did, and they overruled it.

Now, by the reasoning that the opponents here would make, simply because the Court has frequently said the *Pollock case* says so and so, or the teachings of the *Pollock case* are thus and so, they have each time reaffirmed the *Pollock case.*

The Yellow Book lists 22 cases which in this manner have "reiterated and reaffirmed" the *Pollock case*—pages 119–121—in the 44 years since its decision. It is fortunate that the fallacy of such an enumeration of citations can so simply be demonstrated. In *Burnet* v. *Coronado Oil & Gas Co.* (285 U. S. 393, 399–400), the majority of the Court refused to overrule *Gillespie* v. *Oklahoma,* in large part because it had been decided and approved in some 10 cases. In addition to the cases listed in the Coronado opinion, the *Gillespie case* has been cited with approval in nine opinions. These cases are—

Miller v. *Milwaukee* (272 U. S. 713, 175).
Group No. 1 Oil Corp. v. *Bass* (283 U. S. 279, 283).
Fox Film Corp. v. *Doyal* (286 U. S. 123, 130–131).
Indian Territory Oil Co. v. *Board* (288 U. S. 325, 328).
Burnet v. *A. T. Jergins Trust* (288 U. S. 508, 516).
Trinityfarm Co. v. *Grosjean* (291 U. S. 466, 471).
Oklahoma v. *Barnsdall Corp.* (296 U. S. 251, 522).
New York ex rel. Cohn v. *Graves* (300 U. S. 308, 316).
James v. *Dravo Contracting Co.* (302 U. S. 134, 149).

By the simple tests of the Yellow Book, the *Gillespie case* was approved and reaffirmed as late as December 6, 1937, in *James* v. *Dravo Contracting Co.* (302 U. S. 134). Yet, 3 months later, on March 7, 1938, and in spite of the fact that, as the Yellow Book puts it, it was "reiterated and reaffirmed" in 19 cases during the 16 years of its life, the *Gillespie case* was squarely overruled in *Helvering* v. *Mountain Producers Corp.* (303 U. S. 376).

It may be noted, in this connection, that the *Gillespie case* was in considerable part based on the Pollock decision that a tax on the income was a tax on the source.

The Court said:

> In cases where the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such a source, the tax is pro tanto void; *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429; 158 U. S. 601); * * * (p. 505).

The *Coronado case* had a similar foundation, for the Court said:

> To tax the income of the lessee arising therefrom would amount to an imposition upon the lease itself.

If the Court has already overruled decisions based on the *Pollock case*, it is not unreasonable to hope that it would treat the parent case similarly. It is interesting to note that the *Gillespie* and *Coronado cases* are included by the Yellow Book in its list of decisions which "have clearly reiterated and reaffirmed that immunity."

The Yellow Book agrees that the mere power to tax does not necessarily involve the power to destroy (p. 168). It places itself, rather, on the proposition that the tax on bondholders is the destruction of the States and aggrandizement of the Federal Government. We are at a loss to see why, if this be the case, the taxes to be imposed by the States under the proposed legislation will not equally destroy the United States. But, more importantly, it seems plain enough that a nondiscriminatory tax, imposed on the Government bondholder's income equally with that of all others, can threaten no destruction to either government.

The point I now discuss is not important, but the fact that it relates to a foreign system of law makes clarification desirable. We cited the reversal of the immunity rule in Canada and Australia as illustrative of the fact that a federated nation had no practical need of an immunity rule. The Yellow Book does not take issue with our analysis of the holdings, but, instead, as one of its reasons for distinction, categorically states that "a British or Dominion act may not be declared unconstitutional by the judiciary" (p. 207). This statement can be justified only in a highly technical sense; as the many cases cited in the White Book show, the Dominion or Commonwealth Act may be declared ultra vires under the organic act of the British Parliament which establishes the constitutional system.

I know that the committee is impatient, but I do want to mention something before we adjourn. It has been argued that we have rested our position on the authority of Canadian and Australian cases. I think we made it clear that we were making a discussion of that as a matter of interest, as an illustration from experience that a federated system was not destroyed by such taxation.

Finally, before leaving the immunity rule, I wish to rescue two distinguished gentlemen from the position to which Mr. Cohen in his testimony erroneously and, I am sure, inadvertently, assigned them.

He said that Solicitor General Jackson, in the oral argument of *United States* v. *Bekins* (304 U. S. 27), the second municipal bankruptcy case, said that the Federal Government had no power to tax the interest on securities of States and their subdivisions. The statement, according to the transcript of argument, was qualified by the clause which Mr. Cohen neglected to note. Mr. Jackson, stating that he assumed the irrigation district shared the immunity of the

State under the existing decisions, said that there was no power to tax it "under the decisions."

Mr. Cohen also said that Mr. Justice Brandeis, in the *Brushaber case*, said that the burden on the Government, in the case of a tax on the interest received by the bondholder, is a real one.

The Justice, however, was not on the Court at the time that case was decided. The decision, in truth, was by Chief Justice White.

We know of no case in which Mr. Justice Brandeis has said that the Federal income tax cannot constitutionally be applied to the interest paid on State bonds.

Indeed, dissenting in the *National Life case*, he said:

> As the tax imposed by the act of 1921 is on net income, I should have supposed that it was settled by *Flint* v. *Stone Tracy Co.* (220 U. S. 107) * * * that the inclusion in the computation of the interest on tax-exempt bonds, like the inclusion of the receipts from exports * * *, or the inclusion in a State tax of receipts from interstate commerce * * * would not have rendered the tax objectionable.

I will now turn to the argument under the sixteenth amendment. It will not, I think, be necessary to make a very extended reply to the Yellow Book and to the testimony offered here last week.

First. The crucial issue in this regard, as Chairman Brown has pointed out, is the meaning to be assigned to the phrase "from whatever source derived." Mr. Cohen described the phrase as "four clumsy words." I need not elaborate upon the extraordinary character of the principles of constitutional construction which could give rise to such an epithet. The settled rules of construction were expressed by Chief Justice Taney, in *Holmes* v. *Jennison* (14 Pet. 540) in a quite different manner:

> * * * every word must have its due force and appropriate meaning * * *. No word in the instrument, therefore, can be rejected as superfluous or unmeaning.

Mr. Cohen also made an eloquent plea that the committee follow the teaching of Mr. Justice Holmes, and think in terms of things and not words. We are gratified that so distinguished a scholar as Mr. Cohen should reinforce our respect for and reliance upon Mr. Justice Holmes.

As the committee will recall, he dissented in *Evans* v. *Gore* (253 U. S. 245), and insisted that the sixteenth amendment should be construed as we have urged. There, with Mr. Justice Brandeis concurring, he said:

> By that amendment Congress is given power to "collect taxes on incomes, from whatever source derived." It is true that it goes on "without apportionment among the several States, and without regard to any census or enumeration," and this shows the particular difficulty that led to it. But the only cause of that difficulty was an attempt to trace income to its source, and it seems to me that the amendment was intended to put an end to the cause and not merely obviate a single result.

Second: To the best of my recollection, not one of the gentlemen who testified before the committee attempted to explain away the fact that language substantially identical to the "four clumsy words" had been used long before the sixteenth amendment was proposed, and had uniformly been construed to include the income derived from State securities. The Yellow Book offers nothing stronger to explain away this settled construction than the curious thought that, because counsel for both sides, as well as the Court, in the *Pollock case* accepted the natural meaning of the Revenue Act of 1894, its interpretation was not settled. It ignores the fact that Congress rejected, as undesirable, amendments to the 1894 act designed to exempt the interest on State bonds. The Yellow Book makes no attempt whatever to explain away the use of a similar phrase in the Corporate Excise Tax Act of 1909, and the construction of that phrase by the Supreme Court while the amendment was pending before the States for ratification.

Third: The Yellow Book and the witnesses who have appeared before the committee place their reliance in largest part upon the views of Senators Borah and Root and an article by Professor Seligman. If the committee pleases, I yield to no man in my respect for the learning and ability of these gentlemen. But the sixteenth amendment, after all, was proposed by an entire Congress and ratified by an entire Nation. There must inevitably be differences of interpretation, and, if we are to go beyond the words of the amendment, the meaning accepted by the Nation must be gathered from the preponderant interpretation.

I do not wish to extend the time of the committee by pointing out each of the instances where the Yellow Book has misinterpreted or ignored the contemporary evidence.

The committee can readily compare the Yellow and the White Books.

I would not hope to undertake to clear up what may have been misunderstood, and inadvertencies in the brief filed by the opponents, but I do want to ask the committee to read it with the same critical view that they have been asked to read ours, because it deserves a very careful scrutiny to avoid any possibility of being misled. For instance, with respect to the enumeration of all the governors who had taken a position on this matter at the time of the submission of it to the legislatures. We make the confession in the White Book, among others, that Governor Fort's message to the New Jersey Legislature is very confusing, and so I do not undertake to say where he stands.

The Yellow Book criticizes us most severely for considering that confusing, and I just desire to have the committee understand that we have tried to approach this thing in an honest manner, and I want to clear that up.

We can take as illustrative two examples of the type of analysis offered by the Yellow Book. I want to quote as to Governor Fort from the Yellow Book:

The States submit that the Department of Justice is not warranted in attempting to dismiss Governor Fort's message as "confusing." Governor Fort clearly and fully adopted the Borah interpretation when he said:

"Nor am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power. There is no express provision in the Federal Constitution at present prohibiting the Congress from imposing an income tax upon the securities of a State * * * 'It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation.'"

I think the principle of law thus quoted, which is founded upon public policy, would obtain, in construing a constitutional provision, equally as firmly as in the construction of an act of Congress. Words in a constitution are no more forceful, nor are they differently construed, than the same words in a lawfully enacted statute. The Supreme Court of the United States, up to this time, has been the sure reliance not only of the Nation, but of the States.

But the Governor had earlier said:

Criticism of the amendment herewith transmitted is made upon the ground that under it the income upon State or municipal securities might be taxed. Why this should not be I am quite unable to see. The argument made is that a tax upon incomes from this source might (1) decrease the value of such securities in the market; (2) that Congress might, through such a tax, impair the power of the States. Neither of these suggestions seem to me to have force.

Suppose a 1 percent of tax were to be levied upon incomes. Under such a tax the holder of a $1,000 4-percent State or municipal bond would pay an income tax on $40 per year, which would amount to 40 cents per annum.

If the patriotism of our citizens and the interest of our financial institutions, who take and hold State and municipal securities, is at so low an ebb as to cause such a tax to affect the value of State or municipal securities, we are, indeed, in an unfortunate condition in the Republic. No one can believe that such a condition exists.

As to the claim that the Federal Government might injure the States, as such, by taxing State bonds under an income tax, there are two satisfactory answers:

First. The Congress is representative of the States, and elected by the citizenship thereof, and the remedy is in the hands of the people of the States by not returning such Congressmen.

I do not wish to further impose on the patience of the committee this afternoon, but desire to continue my argument tomorrow morning.

The CHAIRMAN. Very well.

Before we recess, I desire to submit for the record a telegram received from Gov. C. A. Bottolfsen, of Idaho, reading as follows:

BOISE, IDAHO, *February 14, 1939.*

Hon. PRENTISS BROWN,
United States Senate:

Idaho opposed to removal exemption of securities of States and their agencies except by their consent and amendment to United States Constitution carrying reciprocal power to tax Federal securities. Believe removal detrimentalto best interests this State.

C. A. BOTTOLFSEN, *Governor.*

(Thereupon at 5 p. m., the committee was recessed until February 16, at 10 o'clock.)

TAXATION OF GOVERNMENTAL SECURITIES AND SALARIES

THURSDAY, FEBRUARY 16, 1939

UNITED STATES SENATE,
SPECIAL COMMITTEE ON THE TAXATION OF
GOVERNMENTAL SECURITES 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.

STATEMENT OF HON. JAMES W. MORRIS—Resumed

The CHAIRMAN. What page of your statement were we on when we recessed yesterday?

Mr. MORRIS. When we rested yesterday, I was discussing some of the illustrations of where we thought we had been unduly criticized for the position that we have taken, and with particular reference the illustration was to the statement that the message of Governor Fort was not confusing, and I read another statement of Governor Fort's which I should like to complete, so that the record might be clear.

The CHAIRMAN. On page 22?

Mr. MORRIS. I have forgotten at what point I was, but I shall pick up that part of Governor Fort's message which says:

> First. The Congress is representative of the States and elected by the citizenship thereof, and the remedy is in the hands of the people of the States by not returning such Congressmen.
>
> Second. The patriotism of our people is such that no Congress could be elected that would lay any tax with a view of destroying the power or integrity of the States. If this be not true, the relation of our States to the Republic is surely of much less importance than many of us have hitherto supposed.
>
> Under a republican form of government the people rule, and they can be safely trusted to see that their representatives make no unjust exactions in the way of taxation or in the curtailing of the rights of the State or otherwise.

Now, all of that is simply to say to the committee that the Department was entirely accurate in its statement that Governor Fort's position was confusing, because it hardly seems consistent with that the message quoted in the Yellow Book.

Now, there is another illustration, purely inadvertent. When the discussion was being had on this question of Federal supremacy, which has been discussed at so great length, and for which we are severely criticized, the distinguished counsel representing the view oppossed to this bill, Mr. Cohen, read from a passage in *McCulloch* v. *Maryland* (4 Wheat. 316), and I will read the paragraph somewhat more fully, and this is the passage read by Mr. Cohen:

> 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 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 their most important and most valuable interests?

And here Mr. Cohen stopped his quotation. At least he overlooked the next two sentences. But I continue the quotation to make clear why we think our insistence that that case was grounded upon Federal supremacy is justified:

In the legislature of the Union alone are all represented. The legislature of the Union alone, therefore, can be trusted by the people with the power of controlling measures which concern all, in the confidence that it will not be abused.

One is tempted to observe that even the most experienced impresarios may occasionally be guilty indeed, of omitting the fortissimo score entirely.

The Yellow Book contends that the data and arguments now advanced by the Department of Justice have, except for the letters of Senator Nelson, been previously considered by the Supreme Court. The reliance in this particular is on *Evans* v. *Gore* (253 U. S. 245). The matters which were considered by the Court in that case are analyzed in the White Book (footnote 572 on p. 213). It seems plain enough that the Court has considered only a small fraction of the evidence presented in our study.

The Yellow Book and the witnesses before your committee have repeatedly expressed a fear that our interpretation of the sixteenth amendment would allow the Federal Government to tax the revenues of States and municipalities. Putting aside the question of activities which are proprietary, or not essential to the continued existence of the States, as does the Yellow Book, we see no basis whatever for this. There is not a word in the amendment which expands the classes of taxpayers subject to Federal taxation. Since a tax on States or municipalities was forbidden by the implications of the Constitution before the amendment, and since that amendment does not enlarge the group of taxpayers subject to the Federal tax, they remain immune after as before its adoption. The fear of our opponents might be justified if the amendment read that Congress "shall have power to lay and collect taxes on incomes, by whomever received and from whatever source derived."

These points seem to us to be the major issues which require clarification in the light of the Yellow Book. It would serve no useful purpose to elaborate our reply to include matters already adequately covered in the White Book, and to which the Yellow Book has offered no sufficient answer.

Senator TOWNSEND. What was the date of the case of *McCulloch* v. *Maryland* (4 Wheat. 316) from which you quoted?

Mr. MORRIS. That was in 1819, as I recall it, but I may well stand corrected on the date.

Mr. GARDNER (Warner W. Gardner, Special Assistant to the Attorney General). That is correct. That is the case from which, we all concede, the doctrine of immunity stems.

Mr. MORRIS. Now, may I say that during my statement yesterday it seems that I used an expression, speaking of the gentlemen of the opposition, "if that term be appropriate"? I want to make it very, very clear to the committee that, in the use of that expression, I intended no possible personal reflection upon the gentlemen of the opposition. I was searching only for an expression that would be apt as to those gentlemen who support the view expressed in the Yellow Book.

I think this is another instance, perhaps, where any possible confusion as to my intention arose from not giving full and complete effect to every one of the words used. I certainly intended the qualifying phrase to apply to the word "opposition," and it was not intended to be played pianissimo.

I will hasten to a conclusion.

Mr. COHEN (Julius Henry Cohen, chairman, law and legislation committee, American Association of Port Authorities). The intention is always that of the man that makes the statement.

Mr. MORRIS. Having been the one who made the statement I am glad that I can clearly state the intention. That I could not do if I had to speak of the intent of a whole Congress. There remains only a word or two to be said in connection with the Government's position in *Graves* v. *New York ex rel. O'Keefe*, now pending before the Supreme Court. Copies of our brief, which will be filed today, will be supplied to the committee.

(The brief filed with the committee is No. 478, in the Supreme Court of the United States, October Term, 1938—*Mark V. Graves, John J. Merrill, and John P. Hennessey, as Commissioners Constituting the State Tax Commission of the State of New York, Petitioners* v. *The People of the State of New York Upon the Relation of James B. O'Keefe*—On writ of certiorari to the Supreme Court of the State of New York—Brief for the United States as amicus curiae.)

Mr. MORRIS. In that case, we agree with Attorney General Bennett and Solicitor General Epstein, of New York, that the State can tax the salary of an employee of the Home Owners' Loan Corporation. Our reasons for this conclusion may be summarized as follows:

First. The Corporation is merely a branch of the Government, and its employee is entitled to whatever immunity may be claimed by any Federal employee.

Second. There is no constitutional immunity from an income tax on the salary of an officer or employee of the States or of the United States.

Third. Congress could provide exemption, but it has not done so, with the result that the tax imposed by New York is valid.

In our view, the first two propositions which I have outlined are completely sound; namely, that the Corporation is simply a branch of the Government, and any employee of that Corporation stands on the same footing as does an employee of any other branch of the Government and, second, there is no constitutional immunity from an income tax on the salary of any officer or employee of the States or of the United States.

Senator AUSTIN. As a matter of fact, in the brief filed by the Department of Justice, amicus curiae, that is, in this case against O'Keefe, in a large part of the brief special emphasis is made upon the effort to have the Court reconsider and overrule *Collector* v. *Day*.

Mr. MORRIS. That is the object in our filing the brief amicus curiae.

Senator AUSTIN. You say, on page 7 of that brief: "We ask that the decision there be reconsidered."

Mr. MORRIS. Exactly.

Senator AUSTIN. And, on page 45 of that brief, you say:

Although *Collector* v. *Day* (11 Wall. 113), has been narrowly confined, it has never been overruled in the 69 years which have followed its decision. It seems well, therefore, that in asking its reconsideration we make our arguments on a broad front, even at the cost of digression from the particular case before the Court.

Mr. MORRIS. That is a reiteration.

Senator AUSTIN. Of that request for reconsideration?

Mr. MORRIS. That is exactly what we are trying to do.

Senator AUSTIN. Substantially the position that you took in the Supreme Court, and the one which you take here, that *Collector* v. *Day* (11 Wall. 113), is the law at this time?

Mr. MORRIS. I did not catch that.

Senator AUSTIN. I say that the principles announced in *Collector* v. *Day* (11 Wall. 113), are the law at this time.

Mr. MORRIS. On the contrary, we are taking the position in the brief that *Collector* v. *Day* (11 Wall. 113), should be overruled.

Senator AUSTIN. You are asking, as I have it, for a declaration of a new principle, are you not?

Mr. MORRIS. I do not believe that I understand the Senator's question.

Senator AUSTIN. Very well.

Mr. MORRIS. We are asking that this case, *Collector* v. *Day* (11 Wall. 113), be reexamined and overruled. We are quite conscious of the situation that the case may not reach that point.

Let me explain, if I may, so that the committee may understand what I mean when I say that.

This is a case where an employee of the Home Owners' Loan Corporation paid a State tax on his income, and seeks its refund, or his liability for it is contested. He paid it, asked for a refund, and the refund was not granted. On appeal, that decision was reversed, and the State of New York seeks to have the Supreme Court reverse the ruling of the State court.

Now, the State law has a provision which exempts Federal employees from the tax. The State supreme court did not, as I understand it, deal with the meaning of that exemption, but with the constitutional question, so the one question—as we contend, the Federal question—before the Supreme Court is that constitutional question.

Now, it may be that this case will be sent back to determine what the State's highest court considers the State statutory exemption to mean.

The CHAIRMAN. Let me interrupt you. I understand that Senator Austin wants to go. But I take it from his question that he means that the request of the Department of Justice that the Supreme Court overrule *Collector* v. *Day* (11 Wall. 113), necessarily concedes that is the law today exactly?

Mr. MORRIS. I said that it had not been overruled.

Senator AUSTIN. That is not my question. My question is: Do you not admit that it is the law?

Mr. MORRIS. I admit that it is the law until it is overruled.

Senator AUSTIN. That is the equivalent of saying that it is the law today.

Mr. MORRIS. I think that we differ as to what is meant by the law.

Senator AUSTIN. Are you not attempting to confuse the principle of what the law is today as you view it with the principle of what the law is in fact?

Mr. MORRIS. I will concede to the Senator that a decision of the Supreme Court until overruled is binding as the law, and that the Supreme Court is the only one that can overrule its decision.

Senator AUSTIN. I hope that you will excuse me for stepping out.

Mr. MORRIS. I just want to make it clear that while we are seeking such judicial clarification, we recognize that the answer may be that an express consent is necessary and, in the absence of consent, there will be no clarification.

We do feel, in frankness to the committee, that we should have explained what our position in that case is.

Now, I think, Mr. Chairman, I will not further burden the committee, unless there are questions, but I should like Mr. Gardner to have the opportunity to supply anything which he thinks I may have omitted in this regard.

Mr. GARDNER. I have nothing to add, but I will be happy to answer any questions.

Senator Austin suggests that the case of *Pickett* v. *United States*, pending in the Supreme Court, may possibly settle the bond issue. The *Pickett case* relates to taxation of an attorney employed by a Missouri township to collect their revenues on a fee basis.

The CHAIRMAN. There is not a clear-cut issue on that proposition.

I have no further questions, and I think I have gotten to the point where my mind contains about all it can. I have asked all the questions on the matters about which I am in doubt, but I do think that we should hear from Mr. Wenchel before we close.

Thank you, Mr. Morris.

We will now hear from Mr. Wenchel.

STATEMENT OF JOHN PHILIP WENCHEL, CHIEF COUNSEL, BUREAU OF INTERNAL REVENUE

Mr. WENCHEL. This committee has been most generous in listening to the arguments presented by the many persons appearing before it. I am fully aware that you are desirous of hastening your executive study and consideration of the material presented. I shall therefore endeavor to be as expeditious as possible.

In the legal brief filed with this committee by the States—the so-called Yellow Book—and in the arguments of some of the States' representatives it has been stated that as late as last year the Treasury Department was of the opinion that a constitutional amendment is the only effective method of subjecting to income tax public salaries and income from public securities. This position, it is claimed, was registered through certain statements of former Under Secretary Magill. In order that the committee have the benefit f all the facts and circumstances incident to the making of those statements by Mr. Magill, I offer for the record the following correspondence. I wrote to Dr. Magill and asked him what his position in the matter was. my letter being as follows:

TREASURY DEPARTMENT, *February 11, 1939.*

Dr. ROSWELL MAGILL,
35 Claremont Avenue, New York, N. Y.

DEAR DR. MAGILL: Following our conversation this morning, I am transmitting you a copy of the so-called Yellow Book on the constitutional immunity of State and municipal securities, filed by the attorneys general of the States, and counsel for certain of their municipal subdivisions, before the Brown committee. Your attention is called to certain statements attributed to you as to the need for a constitutional amendment to eliminate tax immunity. These statements appear on pages 362, 363, and 364.

I shall be greatly obliged to you if you will reexamine these statements and advise me whether in the light of the Gerhardt decision you are still of the opinion expressed in these statements.

Sincerely yours,

J. P. WENCHEL, *Chief Counsel.*

His reply is to this effect:

COLUMBIA UNIVERSITY, SCHOOL OF LAW,
February 14, 1939.

DEAR MR. WENCHEL: You have asked me to give you a statement of my views regarding the proposed statute to end intergovernmental tax exemptions.

I have always believed that the sixteenth amendment was intended to mean, and did mean, what it says—that income from any source whatever should be subject to tax. Dicta in the earlier Supreme Court decisions, however, indicated that the amendment did not enlarge the taxing power. I urged privately and officially that the *Gerhardt case* should be taken to the Supreme Court, in order to determine directly whether the present membership of the Court adhered to the earlier dicta. The decision itself and the reasoning whereby the decision is reached, are strong encouragements to the belief that the Court will now uphold the constitutionality of a statute subjecting the future salaries of State and municipal officials and the interest on future issues of State and municipal securities to the Federal income tax. I hope that such a statute will be passed.

Sincerely yours,

ROSWELL MAGILL.

I want to show you the original of Dr. Magill's letter, because in the mimeographing of that the girls made a "now" a "not" and that just about ruined his letter. There is the original and you can see it.

The CHAIRMAN. You do not suppose that his stenographer made a mistake?

Mr. WENCHEL. No. I do not believe that, sir.

In supporting the President's proposal for the taxing of compensation of public officers and employees and income from public securities, both the Department of Justice and the Treasury Department have at all times endeavored to be completely candid with this committee. They have expressed a confident belief that the President's proposal accords with the tenor of the more recent decisions of the Supreme Court and would be upheld by that Court when they are brought before it.

Mr. COHEN. You mean that you are changing from your manuscript, because your language is different?

Mr. WENCHEL. I am not changing from my manuscript. I am reading from my manuscript.

Mr. COHEN. But you say in the copy of your manuscript handed to me—"They never have and do not now contend that the President's proposal is entirely free from constitutional doubt as to its validity." That is a quite important feature.

Mr. WENCHEL. I am changing that statement.

Mr. COHEN. Are you?

Mr. WENCHEL. Yes.

Mr. COHEN. That is what I want to know. Of course, you have a right to change it.

Mr. WENCHEL. I have changed it. These Departments never have and do not now contend that the President's proposal does not conflict with certain dicta in earlier cases. Those opposing the President's proposals argue that this candor on the part of the Departments is a sign of weakness. To that argument short answer may be made, namely, that in at least the realm of constitutional law one must have a sufficient sense of humility to realize that he cannot with absolute certainty forecast what the Court will do in any given case.

Of course, there is nothing rigid about trends in constitutional law. Even the most expert feel their prophecy to be sheer guess. Only recently, Prof. Thomas Reed Powell of Harvard Law School remarked that the only time he can teach constitutional law to his class with some degree of certainty is during the summer months when the Court is not in session.

There has been presented to this committee by the staff of the Joint Committee on Internal Revenue Taxation a report on "The Power of Congress to Tax the Interest from State and Local Securities and the Compensation of State and Local Employees." One, wholly unlearned in constitutional law, coming upon this report for the first time would think that all that he would have to do to learn anything about constitutional law would be merely to read bare digests of the actual holdings by the Court. The report fails to reflect the obvious: Rules of constitutional law come about as a result of interplay of many factors that must be inquired into aside from the bare holdings of the Court. The dissenting opinion must be read as carefully as the majority opinion, yet, except for a discussion of the *Pollock case* one would be led to believe that all the cases cited in the report were decided unanimously.

In discussing the development of the implied immunity doctrine, the report, in my opinion, treats too cavalierly the reasoning of the Court in *Weston* v. *Charleston*, decided in 1829 (2 Pet. 449). As pointed out in the Department of Justice study, at pages 15 and 21, the dissenting judges in that case indicate that the majority of the Court viewed the tax as a property tax and not as an income tax as stated in the report. If the tax struck down in the *Weston case* was in fact a property tax then obviously the decision is of little comfort to those now opposing the Government. Furthermore, there is really little comfort in the *Weston case* because the State of South Carolina was attempting to tax United States securities.

The report expresses disagreement with the view that Congress apparently has the power under the present trend of decisions to tax interest paid on State and local bonds and to include in taxable income the salaries of State and local officers and employees. This disagreement is predicated on the belief that the decisions in the *Pollock cases* and *Collector* v. *Day* remain basically unmodified by subsequent judicial pronouncements.

The question of the power of Congress to tax as part of net income the interest on State and local securities is approached in the following manner. It is stated that in addition to the holdings that taxes on income from realty and personalty were subject to the requirement of apportionment, the *Pollock case* held that Congress had no power to include in a general income tax the income from State and local bonds. To do this would be to impose a tax on the power of the States and their subdivisions to borrow money and thus be unconstitutional.

It is true, as stated in the report, that in both *Pollock cases* all the Justices agreed that interest on New York City bonds could not be taxed under the act of 1894 imposing a general tax on net income. The unanimity of the Justices, however, does not appear to be based upon a common ground.

Chief Justice Fuller, speaking for a majority of five in the second case, did not treat separately the question of interest from municipal bonds. Neither did the four dissenting Justices make special mention of interest from municipal bonds. In short, one might well say that the question of the interest on municipal bonds was really not fully argued or considered by the Court, and that in the last analysis it did not in fact obtain anything like complete consideration from the Court. Since the whole act was declared unconstitutional it is even not unfair to argue that all the Court said with reference to State and local securities is in a sense merely dictum.

What the report ignores is the basic reasoning of the Court, in the second *Pollock case*. There the Court held that to tax the income from real or personal property would be in effect to tax the source of that income. It followed, therefore, that since the United States could not tax New York City bonds it could not tax the interest from such bonds under an income tax.

That this interpretation of the *Pollock case* is proper is demonstrated by the fact that in *Cohn* v. *Graves* (1937), 300 U. S. 308, where the Court held that the State of New York could subject to income tax rents received by a New York resident from New Jersey real estate, Justices Butler and McReynolds dissenting, were of the opinion that in effect the *Pollock cases* were overruled. Their reasoning was that since a tax on income received for use of land is in legal effect a tax upon land itself, citing the *Pollock case*, New York having no jurisdiction of the New Jersey real estate could not tax the income from such real estate. It is but a short step from *Cohn* v. *Graves* to a holding that even though the United States may not tax State and municipal securities it may, nevertheless, tax the income there from.

Three years after Mr. Pollock won his case a State inheritance tax imposed upon transfer of United States bonds was challenged in the Supreme Court as unconstitutional on the proverbial ground that it impaired the borrowing power of the United States. It was urged upon the Court that if the tax were sustained persons would be driven to consider, when making their investments whether they could rely on their legatees or heirs receiving United States bonds unimpaired by State action in the form of death duties. It was also urged that the result would be that capital would not be invested in United States bonds on terms as favorable to the United States as would be the situation if the tax were held invalid. Nevertheless, the Court was sufficiently realistic in *Plummer* v. *Coler* (1900), 178 U. S. 115, to brush aside such contention in sustaining the power of the State to tax the transfer at death of United States bonds. Two decades later, in *Greiner* v. *Lewellyn* (1922), 258 U. S. 384, the Court sustained the power of Congress to subject municipal bonds to the Federal estate tax.

Obviously, bonds of the State and bonds of the United States would certainly be more attractive to investors if the transfer of the bonds were constitutionally immune from inheritance and estate taxes. In holding that they were not so immune, the Court did not seem to be bothered by any contention that such a tax would constitute a "clog on the borrowing power" of the Government issuing the bonds.

"But," says the Report, "it has never been seriously contended that these decisions would permit the taxation of the bonds themselves" (p. 14). Of course, there is no proposition before this committee for the "taxation of the bonds themselves."

The *Plummer case* did not have to be decided the way it was decided; in fact it was no insignificant victory for equitable taxation. Had that case, as well as the *Greiner case*, never come before the Court, and if the proposition were before your committee to subject State bonds to the Federal estate tax and to permit the States to subject Federal bonds to their inheritance taxes, it can easily be imagined that a great cry of unconstitutionality would be raised.

Senator BYRD. Upon that point, I understand that the Federal bonds cannot be taxed as intangible property in the States?

Mr. WENCHEL. No, Senator.

Senator BYRD. The bond could not be?

Mr. WENCHEL. No, sir; not the bond itself.

Senator BYRD. In other words, it could not be taxed like a bond owned by an individual on real estate?

Mr. WENCHEL. That is right.

Senator BYRD I know the Federal Government could not tax the State bond.

Mr. WENCHEL. That is correct.

Senator BYRD. But the Federal bond in the hands of the holder in those States that have taxation of bonds would be exempt from tax on the principal—on the principal of the bond?

Mr. WENCHEL. Yes; but there is an excise tax on the transfer of both State and Federal securities at death.

Senator BYRD. Upon what theory is that? If the States tax incomes and have laws taxing bonds, why should the Federal bonds be exempt?

Mr. WENCHEL. Well, they are now exempt and so also are the State bonds exempt. Whether they should be exempt is a different matter.

Senator BYRD. No; in Virginia State bonds of other States are taxed——

Mr. WENCHEL. The State taxes them.

Senator BYRD. But my question is this: Virginia has a law taxing all bonds as intangible property, including all out of State bonds; would Federal bonds be different from the taxing of those State bonds?

Mr. WENCHEL. Yes; the State of Virginia, under existing legislation, cannot tax the Federal bonds.

Senator BYRD. I know, but if you recognize the right of reciprocal taxation, could not they tax it as a bond?

Mr. WENCHEL. That involves other considerations. A property tax rather than an income tax would be involved.

Senator BYRD. I know that, but I asked for my information. As a matter of justice, it seems that if the State of Virginia can tax municipal bonds, not only of Virginia but all of the other States, why it should be prohibited from taxing the principal of the bond under the laws of that State. I just want to know if this is a step toward the taxation of the bonds in the hands of individuals, who own the bonds.

Mr. WENCHEL. The consent contemplated in the proposed legislation would certainly not permit the State of Virginia to tax United States bonds as such.

Senator BYRD. I think that they should be taxed like other bonds. You have income taxes and intangible taxes, and I see no reason why Federal bonds should be in a separate class.

Mr. WENCHEL. A step toward that might be considered. Of course, there would have to be express consent by the United States.

Senator BYRD. In other words, what I am anxious to do is to have an equality of taxation, and there is no reason why a State or municipal bond should be taxed in Virginia while some resident owns Federal bonds that are not taxable.

The CHAIRMAN. And I think the proposition is that could very well be included in this type of present proposal.

Mr. WENCHEL. The Federal Government could give the necessary express consent to such taxation.

Senator BYRD. In other words, to put all bonds on an equality?

Mr. WENCHEL. That is right.

Senator BYRD. So far as taxation of Federal bonds as intangible property is concerned?

Mr. WENCHEL. That is right.

Senator BYRD. We ought to put them on the same footing. Some of the States do not have taxation of intangibles and some have.

The CHAIRMAN. I should like to have at the proper time an interpretation from the Treasury Department as to the feasibility of that.

Mr. WENCHEL. That would come from the Secretary, and I will suggest that to Under Secretary Hanes today.

Realistically, *Willcuts* v. *Bunn* (1931) 282 U. S. 216 is another case which weakens the foundations of the Pollock decision. It was held in the former case that it was constitutional for Congress to tax the profit realized by an investor from the sale of municipal bonds. Since, however, the Court did not say that its decision weakened the Pollock decision, the Report assumed that the decision did not modify the principle of the *Pollock case.*

Certainly one district judge and three circuit judges who relied upon the *Pollock case* and then found themselves reversed by the Supreme Court in *Willcuts* v. *Bunn* must have thought that the Supreme Court's decision was really a modification of the principle of the *Pollock case.* The district judge said the tax was unconstitutional because—

> if at the time that any issue of State or municipal bonds is offered to the investing public, it shall be known that any gain or profit realized from a rise in value of such bonds, and a sale thereof would be subject to a Federal tax, which might be increased at any time, this circumstance would operate to discourage the public from dealing in such securities and would cause a reduction in the price which purchasers would be willing to pay therefor. The imposition of such a tax would affect the power of the State or municipality to borrow money and also the amount which could be realized from the sale of its securities. This would be an unjustifiable interference with the financial operations of the governmental subdivision in question and equally with the tax directly imposed on the bonds themselves, and for substantially the same reasons should be held invalid.

The district judge thought the principle of the Pollock decision hard enough to require such a result. Three circuit judges thought the principle of the *Pollock case* hard enough to require the result reached by the district judge. The Supreme Court had to tell all of them differently.

The Report also finds that *Flint* v. *Stone Tracy* (1911) 220 U. S. 107 does not conflict with the *Pollock case;* but to say that a case technically does not conflict with another case is a wholly different matter from saying one case does not substantially weaken the foundations of another case. The *Stone Tracy case* may not necessarily conflict with the *Pollock case*, but it certainly does weaken the basis of the *Pollock case.* Although in the latter case interest from municipal bonds was deemed to be not subject to a general Federal income tax, the *Stone Tracy case* held that it was constitutional to impose an excise tax and measure the tax by interest from municipal bonds.

In other words, it is perfectly proper to collect the same amount of tax from interest on municipal bonds provided the tax takes the form of an excise tax rather than an income tax sui generis. And yet the Report assumes the attitude that the *Stone Tracy case* has not weakened the foundation of the *Pollock case.* This attitude is expressed because similar spurious concepts had found their way into the decisions prior to the *Pollock case.* This can hardly be said to show that a purely formal distinction is a healthy one and does not give rise to questions as to the soundness of a decision that a tax is unconstitutional although the same amount of tax can be constitutionally imposed by a different form of words.

It is interesting to note in this connection the attitude of Senator Aldrich, chairman of the Finance Committee which sponsored the excise tax of 1909 upheld in the *Stone Tracy case.* Senator Aldrich cared little for the niceties of the theory of the 1909 tax.

What is the use—

he said—

of playing upon words? I want to know whether an income tax is not a tax on the same kind [as an excise tax] paying out of the same fund upon the profits. It makes no difference what we call it. It is only a question of words. The Senator from Iowa may say this is an income tax. I may say it is a corporation tax. Another may say that it is a tax upon earnings. Another may say that it is an excise tax. You may characterize it as you please; it is a precise duplication. * * * (44 Cong. Rec. 3242).

It should be noted also that Justices Holmes, Brandeis, and Stone were of the opinion that the *Stone Tracy case* had substantially modified the idea that interest from State and municipal bonds could not be included in an income tax. In his dissenting opinion in *National Life Insurance Co* (1928) 277 U. S. 508, Mr. Justice Brandeis said:

As the tax imposed by the act of 1921 is on net income, I should have supposed that it was settled by *Flint* v. *Stone Tracy* * * * that the inclusion in the computation of interest on tax-exempt bonds * * * would not have rendered the tax objectionable.

Considerable importance is placed by the report on the decision of the Court in the *National Life Insurance Co. case.* A good deal of literature has been written as to whether the Court reached a correct result in that case and frankly it is not my purpose at this time to go into any detail as to the analysis of the reasoning of either the majority or dissenting opinions. It is not at all certain that that case would be decided the same way by the present Court.

Denman v. *Slayton* (1931) 282 U. S. 514, which came several years after the *National Life Insurance Co. case,* should be compared with the latter. The Revenue Act of 1921 provided that in determining net income the taxpayer might deduct from gross income all interest from indebtedness except on indebtedness incurred to purchase or carry securities whose interest was exempt from tax. This meant that if indebtedness was incurred to purchase or carry State or local securities, the interest on such indebtedness was not deductible. Both of the lower courts had held this limitation on the deductibility of interest invalid under the *National Life Insurance case.* It seemed rather clear that the taxpayer was denied a deduction of interest solely by reason of his ownership of the nontaxable securities. Nevertheless, the Supreme Court reversed the lower courts and, in effect, told two district judges and two circuit court judges that they had made a mistake in relying on the *National Life Insurance case.*

One of the principal errors of the report to the joint committee is its failure to recognize between what the Court says and what it does. A number of recent cases are taken up, and because it is found that in these cases the Court has mentioned the *Pollock case* and has not professed disagreement with that case, it is concluded that all must be well with that decision. Too much regard is had for language than for actual decision.

Nor is mention made in the report of a most significant fact, namely, that progressive income taxation casts a wholly different light upon the reasoning and decisions of the cases. Supreme Court decisions can become just as dated as anything else, and what may have been satisfactory in an earlier day must be reexamined in the light of a vastly new taxing system.

The fact is overlooked that the almost universal method by which lawyers present their cases to the courts, when prior decisions seem to stand in their way, is by distinguishing the case at hand from all that has gone before. The reason is not far to seek. Courts generally do not like to be put into the position of being forced to reverse themselves expressly. When a departure from the past is wanted, it is only on rare occasions that lawyers tell the court that to agree with them the court must completely break with the past. On the contrary, the way is made easy for the court, and lawyers point out how the desired is perfectly compatible with all that has been previously said and done.

It is by this road that some strange distinctions come into the law and spurious concepts develop which presage the eventual overturning of the doctrines which were in reality disapproved but in form were distinguished. Everyone knows that when a court says that a previous decision must be limited strictly to its facts it is engaging in euphemism to disguise the more blunt statement that it is in fact overruling that previous case.

It one would know the trend of Supreme Court decisions, he should pay close attention to what the Court does rather than keep his eyes merely on what the Court says. If he looks at the decisions earlier than those at the last term of Court, he will say that a State may subject Federal bonds to the State's inheritance tax and the Federal Government may subject State bonds to its estate tax; that gains from the sale of municipal bonds may be subjected to the Federal income tax; that the Federal Government may impose an excise tax and include interest from State bonds in the measure; and that the State government may impose an excise tax and include interest from Federal bonds in the measure of the tax.

Those are some of the inroads on the doctrine of the *Pollock case,* although one may not be aware of it if he looked only at language and not at actions. When one looks at the decisions at last term of court he sees that the process of limiting immunities from taxation has gone on with tremendous pace. Last term it was held that a State could impose a gross receipts tax upon the receipts which were paid to a contractor for work performed for the United States (*James* v. *Dravo Contracting Co.*, 302 U. S. 134). Overruling two prior decisions, the Court held in the *Mountain Producers case* (303 U. S. 376) that the income received from a State lease by a lessee was subject to Federal income tax. It was also held that the Federal Government could impose an admissions tax on admissions charged by a State University in connection with its athletic events (*Allen* v. *Regents*, 304 U. S. 439).

Much capital is made that *Collector* v. *Day* is as strong now as it was the day it was decided, at least as far as the basic principle thereof is concerned. You have heard expressed the complete surprise that was experienced when the Gerhardt decision came down last May. You have been told that the Circuit Court of Appeals for the Seventh Circuit, in *Commissioner* v. *Stilwell*, decided on January 12 of this year, said that the Supreme Court in the *Gerhardt case* referred to *Collector* v. *Day* by name four times and yet did not overrule the case. I said above that courts are disinclined unless actually pressed to reverse prior decisions. The truth of the matter is that the Government did not deem it necessary in that case to ask the Court to reverse *Collector* v. *Day* in order to win the immediate action against Mr. Gerhardt.

The report asserts that the definition of "gross income" in the revenue act is sufficiently broad to cover compensation of State officers and employees. Hence, it concludes, that no amendment is necessary to adopt the President's proposal with respect to such compensation. On the surface that appears to be a sound conclusion but when viewed in the light of the long-established administrative construction there isn't much to the point. As recently as January 30 of this year the Supreme Court, in *Helvering* v. *R. J. Reynolds Tobacco Co.*, again had opportunity to reiterate the rule that long-established and uniform administrative construction of a statute which does not prescribe precise rules will be considered to have been adopted by the Congress in successive reenactments without change.

It may be that possibly that the rule reiterated by the Court would not be applicable with respect to taxing the future compensation of State officers and employees. But a more fundamental consideration is involved, namely, that the Government's position—and there is nothing sinister about it—would be materially strengthened by an express declaration on the part of Congress that in the future compensation of State officers and employees should be subjected to tax.

An analogy comes to mind. In *Leisy* v. *Hardin* (1890) 135 U. S. 100) the Court held that a State could not prohibit the transportation of liquor in original packages in interstate commerce under its local liquor laws. To counteract the effect of that decision Congress passed the Wilson Act (26 Stat. 313) providing that liquor in original packages shipped into any State should be subject to the laws of that State. The validity of that act was upheld in the case of *In re Rahrer* (1892) 140 U. S. 545.

The rationale of the latter decision is that prior to the enactment of the statute the Court was unwilling to take the initiative in laying down another rule in Federal-State relationship which would permit the States to limit the free passage of commodities in interstate commerce. But once the Congress spoke the Court felt that it had ample justification to support another limitation. In other words, the overt action of Congress will be given great weight and consideration by the Court.

The most recent application of the doctrine of the *Rahrer case* appears in the case of *Whitfield* v. *Ohio* (1936) 297 U. S. 431, upholding the constitutionality of the Hawes-Cooper Act, subjecting prison-made goods in interstate commerce to the laws of the various States.

I now come to that part of the report which sets out the legislative history leading up to the adoption of the sixteenth amendment. It is pointed out (p. 22) that Mr. Cordell Hull introduced two House bills in 1909. The one provided for a general income tax applying to income from property but excluding interest on State and local bonds. The other instructed both the Treasury Department and the Department of Justice to proceed upon the collection of taxes under the act of 1894 (except as they apply to interest on State and local bonds) regardless of the Pollock decision. It is to be remembered that all the judges in the *Pollock case* were apparently agreed on the question of bond interest. If that be the case, and especially in view of what the tenor in Congress was stated to be that is "as conservative as any then in office" (p. 24), isn't it more reasonable to assume that "from whatever source derived" was really inserted to cover bond interest and thus overcome the one point in the *Pollock case* upon which the Court was in full accord?

I do not intend at this late hour to reexamine all of the historical data in connection with the enactment of the sixteenth amendment. I believe sufficient data has been presented to the committee by the Department of Justice in its study and in my brief supplied on January 18 to apprise the committee of our position.

Nor do I wish to burden the committee again with also repeating what the position of the Treasury Department is with respect to the judicial interpretation of the sixteenth amendment. I merely call your attention again to the material which I presented at the January 18 hearings of this committee.

But as the report to the joint committee omits the genesis of the phrase "from whatever source derived," I shall very briefly review it.

In the Civil War Income Tax Acts, in the act of 1894, and in the very Corporation Excise Tax Act of 1909 (the latter act being passed by the same Congress that started the sixteenth amendment on its way) all had wording that were similar to "from whatever source derived." The constitutional question in *Collector* v. *Day* had to be decided becauos the compensation of State officers and employees were deemed to have been included in the Civil War Income Tax Act before the Court. The constitutional question in the *Pollock case*, insofar as it involved interest on New York City bonds, also was considered because the wording used in the act of 1894 was deemed to have included such interest. The constitutional question in *Flint* v. *Stone Tracy* had to be decided because interest from State and local securities were deemed to have been included under the wording of the 1909 act.

In the light of that information, who is the more unreasonable, the one who says "from whatever source derived" really means nothing or the one who says that "from whatever source derived" is to be given the same meaning that its progenitors had in prior acts? I cannot refrain from calling the attention of this committee to an article written by the late Dwight Morrow in 1910 in 10 Col. L. Rev., page 379, shortly after the submission of the sixteenth amendment for ratification. Speaking of the opinion expressed by Governor Hughes as to the meaning of the amendment, Mr. Morrow said as follows (pp. 410–411): *

Senator Burkett, on July 5, 1909, voted in favor of the proposed sixteenth amendment; but Senator Burkett, on April 26, 1909, in the debate upon Senator

Bailey's proposed income tax law, spoke as follows with reference to the taxing of State securities:

"But how are you ever going to get over the unfairness in the case of the man who has his million, say, invested in county, State, municipal, district, and United States bonds? The Senator specifically exempts them. How are you ever going to make the law fair in the case of that kind of a man, who, in my opinion, contributes the least to society and the least to the Government of any other man on earth?" (Congressional Record, vol. 44, p. 1540.)

We are not now concerned with a defense of this useless man who has loaned all of his property to his Government. Senator Burkett's words would be of little interest standing alone. They do acquire a great interest however in the light of Senator Root's statement that "no one claimed that the inability" to tax State securities "was an evil." Senator Bailey explained to Senator Burkett that the Constitution compelled him to make such an exemption. Can it not be fairly claimed that Senator Burkett at least voted for the submission of the sixteenth amendment, having in mind that with the Constitution so amended he would thereafter be able to "get over the unfairness" of being compelled to exempt State and municipal securities.

But it should be borne in mind that the burden of proof is not upon Governor Hughes but upon Senator Root. Governor Hughes distinctly anticipates Senator Root's argument. He grants the possibility of such a construction but says that no satisfactory assurance can be given that it will be followed. We have a practical unanimity of opinion that it was the intention of Congress to tax State and municipal securities under the Wilson law. We have two of the ablest lawyers of the United States arguing for the constitutionality of such a power. We have a strongly expressed belief on the part of many that such a construction would not be a bad thing. We pass an amendment of the Constitution to change the law as laid down in the *Pollock case*. One of the things laid down in the *Pollock case* was that State and municipal securities could not be taxed even under an income tax. The sovereign people use substantially the same language in the sixteenth amendment as was used by Congress in the Wilson Act, which language the Supreme Court evidently thought included State and municipal securities. What possible assurance can Senator Root give Governor Hughes that the Supreme Court will not quote again, as Chief Justice Fuller quoted in the *Pollock case*, the following words of Chief Justice Marshall:

"It is not enough to say, that this particular case was not in the mind of the Convention, when the article was framed, nor of the American people, when it was adopted. It is necessary to go further, and to say that, had this particular case been suggested, the language would have been so varied, as to exclude it, or it would have been made a special exception. The case being within the words of the rule, must be within its operation likewise, unless there be something in the literal construction so obviously absurd, or mischievous, or repugnant to the general spirit of the instrument, as to justify those who expound the Constitution in making it an exception." (4 Wheat. 518,644.)

The Chairman. I have had a thought somewhat along the line of the argument. It may have been discussed some time during my absence. It seems to me when a man makes an argument, we ought to look back of the argument and find out why he takes a position that way.

I do not mean to imply any bad faith, of course, on the part of any of these gentlemen, but Senator Brown, of Nebraska, and Senator Bailey and Senator Borah were all advocates of the income tax. They desired that it be pressed; that it be adopted by the various States after it passed the Congress. It is conceivable they took the positions that they did to aid in the adoption of the amendment by the States, and what they said they thought was helpful to that end.

I think Professor Seligman's attitude was the same. He was an earnest advocate of the income-tax amendment, but he took the view as appeared in the press in the opposition that the income tax did not cover State and municipal bonds. I think his opinion might have been caused by his desire to see it passed and he thought it would pass the State legislature a little more easier if it was construed not to include interest on State bonds.

Governor Hughes was opposed to the income tax if it affected State bonds. He desired to see it defeated. I think the reason for the action of these men is somewhat pertinent to this discussion.

Mr. WENCHEL. Well most of the expressions that we have heard was of course after the amendment had gone through the Congress and was on its road for the ratification by the States.

The CHAIRMAN. Oh, yes.

Mr. WENCHEL. There is very little in the debates that is instructive after it was passed; the thought I have always had was that one thing the courts in the two Pollock cases had been unanimous upon was the taxation of municipal bonds.

The CHAIRMAN. That was the reason that the *Pollock case* was there.

Mr. WENCHEL. That is right. Now, on the other hand, apparently in the Congress they were trying to get over that same hump that the court could not overcome with respect to income from municipal securities. It seems to me that is exactly what was meant by the insertion of "from whatever source derived." I might say I entertained that idea even before the President's message.

Last spring when asked to address the Federal Bar Association, I chose that subject—even before the President's message of April 25. I merely state that as to taxability of income from State and local securities under the sixteenth amendment. I have always had that feeling, and it was not the President's message that gave it to me.

Mr. GARDNER. Governor Hughes stated that he was in favor of the income tax but did not like this particular amendment. He says:

> I am in favor of conferring upon the Federal Government the power to lay and collect an income tax without apportionment among the States according to population.

Senator BYRD. Then he was not in favor of an income tax, but he was opposed to this particular amendment.

Mr. GARDNER. I think that is a fair statement.

The CHAIRMAN. I want to ask Mr. Cohen was Professor Seligman's argument to which we have referred written before the adoption of the amendment or was it written afterwards?

Mr. COHEN. Afterwards.

The CHAIRMAN. Well what I say would not apply to Professor Seligman's view. While we are in this short interruption, Mr. Tobin, I want to be correct in my understanding of the contention.

Mr. TOBIN (Austin J. Tobin; secretary of Conference on State Defense). All these assurances were given after submission but before ratification.

The CHAIRMAN. My point that Professor Seligman, as an advocate of the amendment, desired that it be, of course, passed, and he was endeavoring to give it a construction which would be to that end, and that is the argument.

Mr. TOBIN. I cannot assume that Senators Borah, Root, and Professor Seligman would deceive the States as to the amendment and let the States proceed with ratification with these assurances in mind.

The CHAIRMAN. I do not like the word "deceived." I have often found myself in going into lawsuits with the view my client was wrong, but, with me—and I think, with most lawyers—after a few weeks of study and living with the case, one comes to the other conclusion. It was on the basis of these assurances and upon the assurances of

Senators Borah and Root that the New York Legislature ratified the sixteenth amendment.

Mr. TOBIN. I know the Senator did not mean that they intended to "deceive" but what I meant was that the amendment constituted a change of national policy, and was of considerably more weight than ordinary matter. It was solemnly submitted to the States on the basis of these interpretations, formally made and placed before the people as the entire basis of their ratification of the amendment. They were assured, without dissenting voice, by the very Senate that submitted it to them that the words "from whatever source derived" did not have the meaning here contended for. The character and prominent standing of Senators Borah and Root and of Professor Seligman makes such interpretation, in our opinion, inconceivable.

Mr. COHEN. On the principle, when the Federal Constitution was submitted for ratification, there were many views as to the interpretation to be put on certain provisions of the Constitution, and, in the effort to assure the ratification both Hamilton and Madison wrote articles. Of course, Hamilton wanted it adopted, and so did Madison, but we lawyers quote from them today for the purpose of finding out what the interpretation was, and we quote from the articles written by them. We do say things that perhaps on reflection we would like to revise, and that occurred here this morning. Mr. Wenchel previously prepared a statement of which I have a copy that he felt bound to change, and nobody objects to that, but the point I want to bring home is that when one comes to the history of the Constitution, solemn assurances are given by those who urge the ratification of the Constitution. You see it is appropriate for the ordinary mind to accept those statements with a view of certainty, not merely of the views of the men who express them, but the understanding of the people who rely upon them.

You and I do not in terms of estoppel discuss the Constitution, or discuss estoppel in terms of constitutional law, but if you should bring a contract and submit it to me to interpret there are certain obvious things provided to be done in it, and you write me there is no such intention as that in the contract, and I accept that statement there was no such intention and advise my client to such effect, I cannot come back later and say that the Senator was so zealous to get my letter in return, that, when I accepted the statement there was no such intention, and so I say that Senator Borah and Senator Root and Professor Seligman are the advocates who stated to the State what they did, and they cannot back up.

And there is a principle of simple estoppel that precludes them from saying that they said that, but that the words actually meant something else. What he said concurrently at the time of the discussion of the Constitution, or at the time of the adoption of the amendment by those who favor it has always been used by lawyers as an interpretation of intent.

The CHAIRMAN. I agree with the force of that argument, but I think it perfectly proper to inquire, as we do of witnesses in court, whether they are biased or interested in the matter, and I want to say here, as I have said on other occasions, that I do not mean in any way to impute any dishonest purpose to what these gentlemen said. I simply pointed out that they were advocates of this particular amendment. There is no man in the United States since the Civil War whom I would place above Senator Borah in my estimate of the man and statesman.

Mr. WENCHEL. May I answer first Mr. Tobin, and then Mr. Cohen. I am quoting from my speech of last May before the Federal Bar Association:

"A constitution," Mr. Justice Holmes has reminded us, "is not intended to embody a particular economic theory." The Supreme Court has already extricated itself from the legal economics of the *Pollock case* without looking to the sixteenth amendment for legal justification. But, should the sixteenth amendment be disregarded?

In submitting that amendment to the legislation of New York, Chief Justice Hughes, then Governor of that State, warned the legislature that the words "from whatever source derived" would extend the taxing power to income previously exempt. Senators Borah and Root disagreed with Governor Hughes. Nevertheless, Governor Dix, who succeeded Governor Hughes, urged the Legislature of New York to ratify the sixteenth amendment in these words:

"Indeed, it seems to me that if the words 'from whatever source derived' would leave the amendment ambiguous as to its power to tax income from official salaries and from bonds of States and municipalities, the amendment ought to be opposed by whoever adheres to the democratic maxim of equality of laws, equality of privileges, and equality of burdens * * *. It is impossible to conceive of any proposition more unfair and more antagonistic to the American idea of equality and democratic principle of opposition to privilege, than an income tax so levied that it would divide the people of the United States into two classes."

Now, as to Mr. Cohen's statement, may I use this quotation from the case of *McCulloch* v. *Maryland* (4 Wheat. 433):

In the course of the argument, the Federalist has been quoted, and the opinions expressed by the authors of that work have been justly supposed to be entitled to great respect in expounding the Constitution. No tribute can be paid to them which exceeds their merit. But, in applying their opinion to the cases which may arise in the progress of our Government, a right to judge of their correctness must be retained; and, to understand the argument, we must examine the proposition it maintains and the objections against which it is directed.

What has been said here before you touches upon the vital problem of the intergovernmental relationship between States and the Nation. To that extent we are in accord with those appearing in opposition to the President's proposal. But we soon part company in the matter of the effect of such proposals on Federal-State relationships. So long as our American form of republican Government exists, the controversies over the respective spheres of State and Nation will from time to time arise—and if the teachings of history are reliable, every one of those controversies makes the people of this country a stronger Nation.

A host of fears have been expressed before this committee as to what might happen in the future once the President's proposals be enacted into law. The committee has been warned that should Congress adopt such proposals a fuse will have been lit, eventually setting off the destruction of the States. And all of these fears arise from a simple proposal to end in this democracy the anomaly that certain public officers and employees and private holders of public securities are deprived of their respective privileges of supporting both the Federal and State Governments in the form of an income tax upon their compensation or income from such securities.

I pointed out to this committee on January 18, that the President's proposal is limited to the taxation of income in the hands of private persons. Of course, that proposal does not call for the taxation of income in the hands of States or their political subdivisions. The Congress, as pointed out by Chief Justice Marshall in *McCulloch* v.

Maryland, and by Mr. Justice Stone in the Gerhardt decision, affords ample protection to the States from any attempt at their destruction by the exercise of Federal power.

You have heard, time and time again, that, though the present Congress can be trusted to do what is just and right, what assurance is there that future Congresses, once given the tremendous leverage afforded by the enactment of the President's proposal, from riding roughshod over States' rights? This is merely an argument in terrorem. To borrow an expression used in the Yellow Book, the opposition play up fortissimo virtually impossible situations, and play down pianissimo practical realities.

Is it at all reasonable to assume that so long as the Supreme Court sits Congress would be held to have the power to destroy the States? Furthermore, is it reasonable to assume that Congress would destroy the source of revenue by an arbitrary use of the taxing power?

Lastly, proponents of such arguments display small regard for the integrity of future legislators. The fact that forbearance and discretion are exercised by legislators because realities require such exercise seems to have been wholly overlooked.

To enact into law the President's proposals, it is said, would be only for the purpose of bringing pressure upon the Court. Is this to be understood as meaning that the Court will involuntarily uphold the constitutionality of a law which at least the majority of the justices think is unconstitutional? Or do the proponents of the pressure argument really mean to hide by indirection their realization that the tide of judicial treatment of intergovernmental tax immunity is already running heavily against them? Otherwise, why express such resentment at an attempt to obtain judicial approval of congressional legislation in a manner no different from that followed these past 150 years? Are such proponents really afraid of the doctrine that a congressional statute must be given the benefit of any doubt when its constitutionality is questioned?

The CHAIRMAN. Going back to the point that you just covered; that is, the possibility that a future Congress might eliminate the reciprocal feature of this act: Let us suppose a situation whereby the Senate passes the House bill, and that it was followed by a bill authorizing reciprocal taxation of Federal and State bonds, such as your complete proposal, and it went to the Supreme Court and was sustained. Suppose that a subsequent Congress took away from the States, by legislative enactment, the right to tax Federal securities and salaries, do you think that such a situation would make any difference in the constitutional power of the Federal Government to tax State securities?

Mr. WENCHEL. I do not know.

The CHAIRMAN. Well, that is the point that they make. In other words, there would be no protection to the States in the event that kind of action was taken, and the argument is, therefore, that the immunity should be constitutional rather than statutory.

Mr. MORRIS. May I suggest something on that point?

The CHAIRMAN. Yes.

Mr. MORRIS. I think we have repeatedly made the point, and it has been stigmatized as pressure upon the court, that the court might believe that the proposed tax was justifiable and constitutional and nondiscriminatory by reason of the fact that a similar right had been extended to the States. If that be the gist of the decision, then one can conceive a situation where, in the absence of that reciprocity, there might be constitutional defects in the other. I just say that as being a thought. I do not pretend to say that would be the result.

Mr. GARDNER. Might I add a further bit of information in regard, first, to the suggestion that you have made along the line, and, second, to rescue our proposal from the charge of immorality that Mr. Cohen has suggested.

This deals with the Governors who sent messages to the legislatures in connection with the ratification of the sixteenth amendment, and I have no desire to take up the time of the committee to tabulate them one by one, but it is sufficient to say five of the Governors were included in the list of the seven in disagreeing with the Hughes' interpretation. All of these Governors said that they did not know who was correct, Hughes or Borah, but that, in any event, a Congress, which was made up of representatives of the States, would assuredly offer sufficient protection, and we have gone through a century and a half of constitutional government with the representatives of the States composing the Congress. I think that nowhere, with the possible exception of the reconstruction days, which made a slight deviation later rectified, has there been any effort on the part of Congress to infringe on the States' sovereignty or to treat them unfairly in taxation. Such was the view of the five Governors.

Mr. WENCHEL. I may say this, Senator, that in the *O'Keefe case*, as Attorney General Morris has called to your attention, the Government has taken the position that the States have the right to tax salaries of Federal employees.

The CHAIRMAN. As I understand it, the case you have in mind is with reference to an employee of the Home Owners' Loan Corporation with residence in the State of New York. Do I understand that, under your concession, the State of New York now has the right to tax the salary of the President of the United States?

Mr. WENCHEL. Yes, sir.

The CHAIRMAN. You take that view?

Mr. WENCHEL. Absolutely.

The CHAIRMAN. You think that that right now exists?

Mr. WENCHEL. Yes; that is the position of the brief.

The CHAIRMAN. So, you take the position that the State of New York now has the right to tax any Federal official, and I see Mr. Cohen nodding his head, and, I take it, that pleases Mr. Cohen.

Mr. WENCHEL. At least one present member of the Court does not feel that it is wrong for Congress to pass a law in order to test its constitutionality. The insurance provisions of the Revenue Act of 1921 held invalid in *National Life Insurance Co.* v. *United States* heretofore mentioned were drafted in a sense with the assistance of all the large insurance companies in this country.

Mr. Chairman, I would like to have inserted in the record the following declaration of policy contained in the New York income-tax law.

Section 1 of the 1937 amendment to the New York State income tax law (Laws of New York, 1937, ch. 744, in effect May 28, 1937) reads as follows:

Declaration of policy.—The taxes imposed by article 16 of the tax law upon and with respect to personal incomes, being taxes for the support of the government of the State and its municipalities, and being measured by ability to pay, as evidenced by the amount of income received, are, in no just and proper sense, to be considered as a reduction in the salaries or compensation of public officials and judges, but, on the contrary, are for the purpose of establishing the amounts which public officials and judges, as well as other citizens, and those who derive benefits from government, should pay for the benefits so derived. In a certain sense, every tax, which a public official or judge is required to pay, diminishes his salary, but it is not believed that the people, when they adopted the Constitution, contemplated that a tax which falls equally upon all citizens should be regarded as diminishing the compensation of public officials and judges. The legislature finds that the taxes imposed by article 16 of the tax law in no sense discriminate against public officials and judges, but apply to them only to the extent that they apply to others having incomes and deriving benefits from the government of the State. It is hereby declared to be the policy of the State that salaries and compensation of public officials and judges shall be subject to personal income taxation under the laws of this State. Equality or burden is a cornerstone of sound tax policy. Inequality results where the burden of taxation is unequally distributed.

Mr. Charles Evans Hughes filed a brief by special leave of the Court sustaining the validity of the challenged legislation on behalf of the Metropolitan Life Insurance Co. and others. This occurred 2 years before Mr. Hughes went on the Bench in 1930.

The Department of Justice in its study has pointed out that the Court, in *Evans* v. *Gore*, not only did not frown upon a congressional attempt to obtain judicial pronouncement on the validity of a statute as to which doubts were expressed, but actually countenanced such a procedure.

As early as 1827, Mr. Justice Washington, in *Ogden* v. *Saunders* (12 Wheat. 213, 270), after observing that the question in that case was a doubtful one, said:

> But if I could rest my opinion in favor of the constitutionality of the law on which the question arises, on no other ground that this doubt so felt and acknowledged, that alone would, in my estimation, be a satisfactory vindication of it. It is but a decent respect due to the widsom, the integrity, and the patriotism of the legislative body by which any law is passed to presume in favor if its validity, until its violation of the Constitution is proved beyond all reasonable doubt. This has always been the language of this Court, when that subject has called for its decision; and I know that it expresses the honest sentiments of each and every member of this Bench.

This committee has ample legislative precedent for recommending favorably the adoption of the President's proposal. I call your attention to the fact that when the National Industrial Recovery Act was before the Senate on June 8, 1933, Senator Clark recommended the amendment of section 22 of the Revenue Act of 1932 to provide that the interest of State and local securities should be subject to Federal income tax. The amendment was adopted by a 45-to-37 vote with 14 Senators not voting. Of those 45 Senators who voted in favor of Senator Clark's amendment, 24 are still members of the Senate.

It is interesting to note that the Clark amendment applied to outstanding securities as well as to prospectively issued securities. The amendment was stricken out in conference.

[Excerpt from Congressional Record, 73d Cong., 1st sess., vol. 77, pt. 6, June 8, 1933-June 16, 1933 (at pp. 5420-5421)]

Mr. CLARK. I offer the amendment which I send to the desk.

The PRESIDING OFFICER. The amendment will be stated.

THE LEGISLATIVE CLERK. On page 42, between lines 8 and 9, it is proposed to insert the following new paragraphs:

Effective as of January 1, 1933:

(1) Section 22 (a) of the Revenue Act of 1932 is amended by inserting before the period at the end of the first section thereof a comma and the following: "including obligations of the United States or its possessions, and of any State, Territory, or any political subdivision thereof, or the District of Columbia."

(2) Paragraph (4) of section 22 (b) of the Revenue Act of 1932 is amended to read as follows:

"(4) Tax-free interest: Interest upon securities issued under the provisions of the Federal Farm Loan Act, or under the provisions of such act, as amended: Every person owning any of such securities shall in the return required by this title submit a statement showing the number and amount of such securities owned by him and the income received therefrom, in such form and with such information as the Commissioner may require."

Mr. CLARK. Mr. President, at this hour of the night I do not desire to detain the Senate by debating this amendment. It is a subject on which every Member of the Senate has, undoubtedly, already made up his mind. It is a question upon which the equity, the wisdom, and the legality have been debated on both sides at great length. Suffice it to say, I believe that closing the door to what are called tax-exempt securities will close the greatest gap in our income-tax system, with the possible exception of the gap which now occurs through the capital-losses provision of the present income-tax law. I believe it is desirable from every standpoint to close those gaps, because of the glaring injustices in the administration of the income-tax law.

Briefs have been written, speeches have been made, about the question of the power of Congress, under the present state of the Constitution, to tax these tax-exempt securities. As was said earlier in the evening by the Senator from Idaho, I cannot read the sixteenth amendment to the Constitution in any other way than as giving Congress the power to tax these hitherto tax-exempt securities. I believe that the sixteenth amendment, when it declared that Congress had power to tax incomes from whatever source, meant exactly what it said, and that it overruled the previous rulings of the Supreme Court to the effect that Congress had no power to tax these securities.

I offer this amendment for the purpose of testing the sense of the Senate, and do not desire to debate it at any length.

The PRESIDING OFFICER. The question is on agreeing to the amendment offered by the Senator from Missouri [Mr. Clark].

Mr. CLARK. I ask the yeas and nays.

The yeas and nays were ordered, and the legislative clerk proceeded to call the roll.

Mr. MCNARY (when his name was called). Again referring to my pair, I withhold my vote. If permitted to vote, I would vote "nay."

The roll call was concluded.

Mr. HEBERT. I desire to announce the following general pairs:

The Senator from Vermont [Mr. Dale] with the Senator from California [Mr. McAdoo], and

The Senator from Pennsylvania [Mr. Davis] with the Senator from Kentucky [Mr. Logan].

Mr. KENDRICK. I desire to announce that the Senator from Washington [Mr. Bone], the junior from Virginia [Mr. Byrd], the senior Senior from Virginia [Mr. Glass], and the Senator from Illinois [Mr. Lewis] are necessarily detained from the Senate.

I also wish to announce that the Senator from Nevada [Mr. Pittman] is absent in attendance on the London Economic Conference.

The result was announced—yeas 45, nays 37, as follows:

YEAS—45

Ashurst	Cutting	Norris
Bachman	Dickinson	Nye
Bankhead	Dill	Pope
Barbour	Duffy	Reynolds
Black	Erickson	Robinson, Ind.
Borah	Frazier	Russell
Bratton	Hayden	Sheppard
Brown	Kean	Shipstead
Bulow	Kendrick	Smith
Byrnes	La Follette	Steiwer
Capper	Long	Thomas, Okla.
Caraway	McGill	Thomas, Utah
Clark	McKellar	Trammell
Coolidge	Murphy	Walsh
Costigan	Neely	Wheeler

NAYS—37

Adams	Hale	Robinson, Ark.
Austin	Harrison	Schall
Bailey	Hastings	Stephens
Barkley	Hatfield	Thompson
Bulkley	Hebert	Townsend
Carey	Keyes	Tydings
Connally	King	Vandenberg
Copeland	Lonergan	Van Nuys
Dieterich	McCarran	Wagner
Fess	Metcalf	Walcott
George	Overton	White
Goldsborough	Patterson	
Gore	Reed	

NOT VOTING—14

Bone	Fletcher	McAdoo
Byrd	Glass	McNary
Couzens	Johnson	Norbeck
Dale	Lewis	Pittman
Davis	Logan	

So Mr. Clark's amendment was agreed to.

A few days ago the country celebrated the birthday of Abraham Lincoln. Lincoln was a lawyer, but he had little patience with legal dialectics. In his first inaugural address, he said:

> The candid citizen must confess that if the policy of the Government upon vital questions affecting the whole people is to be irrevocably fixed by decisions of the Supreme Court the instant they are made in ordinary litigation between parties in personal actions, the people will have ceased to be their own rulers, having to that extent practically resigned their Government into the hands of that eminent tribunal.

These words are prophetic. Today, when there is a world-wide collapse of democratic governments, we, in this country, pause before enacting merely a short and simple statute which would give this country a democratic income-tax system based upon ability to pay because 44 years ago a private individual named Pollock, who owned stock in the Farmers Loan & Trust Co. of New York, won a lawsuit to prevent his corporation from paying an income tax on interest from some municipal bonds issued by the city of New York.

Let us be more realistic and less doctrinaire. When Pollock won his lawsuit against his bank, it was common practice for governments to issue their securities free from all forms of taxation. It was not recognized in 1894 that the graduated income tax was the most just means for distributing the costs of government. The operation of such a system of taxation was not then fully understood. Nor was it then recognized that tax-exempt securities would menace the existence of an equitable system of progressive income taxation.

Today the situation is vastly different. Because of the existence of tax-exempt securities an ever-increasing amount of wealth is withdrawn from the National and State taxing power. The capital investment market is dislocated by reason of men of great means locking up huge portions of their funds in tax-exempt securities. The States, as well as the Nation, are thus deprived of revenues which could be raised from those best able to supply them. Neither the States nor the Nation receive any compensating advantage equivalent to the subsidy they confer upon the holders of these tax-exempt securities.

All these altered facts of political economy and public finance, considered in connection with the unfair consequences of immunity from income taxation, require that an opportunity, at least, be afforded to the Supreme Court to reexamine the doctrine of reciprocal immunity which it announced in the *Pollock case*. This can only be done if Congress repeals the present statutory exemption from taxation of interest received by private owners of State and municipal securities.

Then a Supreme Court better informed as to the actual functioning of the graduated income tax in a complex industrial economy than the Supreme Court which decided the *Pollock case* will have an opportunity of passing on its constitutionality.

Granting everything that every opponent of the President's proposal has said, the fact still remains that never since the *Pollock case* has Congress taxed directly the income from State and municipal securities. And thus never since the graduated income tax became an accepted part of our taxing system has the whole question of tax-exempt securities ever been presented for reconsideration to the Supreme Court.

Yet we all know that the Court is constantly reconsidering its decisions in the light of the basic principles of the Constitution on which they are based. Lawyers, as well as laymen, agree with Mr. Justice Holmes that it is revolting to have no better reason for a rule of law than that it was laid down in some earlier decision of the Court, and still more revolting if the grounds upon which it was laid down have vanished long since, and the rule persists from blind imitation of the past.

The Supreme Court of Illinois, for example, had no hesitancy in *People* v. *Bruner*, (1931), 175 N. E. 400, in throwing on the judicial ash heap a century of Illinois precedents as to the constitutionality of a statute making the jury the judge of both law and facts in a criminal proceeding. *Erie Railroad Co.* v. *Tompkins* (1938) 304 U. S. 64 overruling *Swift* v. *Tyson*, (1842), 16 Peters 1—after 96 years—is so recent that a lot of people are still wondering as to what happened.

In the *St. Joseph Stockyards case* (298 U. S. 38), Justices Stone and Cardozo both agreed that—

> The doctrine of stare decisis, however appropriate and necessary at times, has only a limited application in the field of constitutional law.

It may be true that there is considerable dicta, hanging like a shroud around the Court, adverse to the constitutionality of a statute to end tax-exemption privileges of future municipal bondholders. But the Supreme Court is bound by its own precedents only to the extent it believes them sound. And this rule is itself a precedent. In the *Passenger cases* (7 How. 283, 473), Chief Justice Taney stated that it could be regarded—

> as the law of this Court, that its opinion upon the construction of the Constitution is always open to discussion when it is supposed to be founded upon error, and that its judicial authority should hereafter depend altogether on the force of the reasoning by which it is supported.

Knowing these things, knowing that Republican as well as Democratic Presidents have urged the abolition of tax-exempt securities as economically unsound and politically unnecessary, knowing that the discretion and reason of the Justices of the Supreme Court is not cramped by legalisms, why should not the Congress repeal the statutory exemption now in the Revenue Act?

I am not now urging that the amendment method should never be tried. But I do urge that it is difficult, even if considered advisable, to amend a constitution to say what it already says. We have had at least one experience.

In *Chisholm* v. *Georgia* (2 Dallas 419), the Supreme Court held it had jurisdiction of a suit against Georgia by a citizen of another State. The eleventh amendment was then adopted providing that the judicial power did not extend to a suit against a State by a citizen of another State. In *Hans* v. *Louisiana* (134 U. S. 1), the Court had before it, 90 years later, a suit against a State by one of its own citizens. And the Court decided that the constitution as originally written did not authorize a suit against a State by any citizen without the State's consent.

Thus, the eleventh amendment was not only not needed, according to the Court, but it was defective.

It is safe to predict that the Supreme Court would today permit the sixteenth amendment, with its sweeping language, to mean just what it says, if the Congress will grant it the opportunity.

Let us be realistic again. There are nine Justices of the Supreme Court.

The Chief Justice said, in the *Dravo case* (302 U. S. 134), that the effort of the Supreme Court would be "in this difficult field to apply the practical criterion" and in the *Mountain Producers case* (303 U. S. 376) that "regard must be had to substance and direct effects."

Mr. Justice Stone dissented in the *National Life Insurance Company case*, and in the *Port of New York case* said:

> The State and National Governments must coexist. Each must be supported by taxation of those who are citizens of both. The mere fact that the economic burden of such taxes may be passed on to a State government and thus increase to some extent, here wholly conjectural, the expense of its operation, infringes no constitutional immunity. Such burdens are but normal incidents of the organization within the same territory of two governments, each possessed of the taxing power.

Mr. Justice Stone also wrote the opinion in *Cohn* v. *Graves*, which Justices Butler and McReynolds held overruled the *Pollock case*.

Mr. Justice Roberts dissented with Mr. Justice Brandeis in *Brush* v. *Commissioner* (1936) 300 U. S. 352, 375, since overruled sub rosa by the *Port of New York Authority case*, saying

> It seems to me that the reciprocal rights and immunities of the National and a State Government may be safeguarded by the observance of two limitations upon their respective powers of taxation. These are that the exactions of one must not discriminate against the means and instrumentalities of the other and must not directly burden the taxing power.

Mr. Justice Reed concurred with the majority opinion of Mr. Justice Stone in the *Gerhardt case*, and in an earlier case upholding a State privilege tax as applied to an engine by means of which natural gas was transported to purchasers in other States, declared that although the tax "obviously adds to the cost of the interstate commerce," nevertheless "increased cost alone is not sufficient to invalidate the tax as an interference with that commerce" (58 Supt. Ct. 736). We have already seen that the analogy between a tax on net income including income from interstate commerce and a tax on net income including income from tax-exempt bonds is very direct.

Mr. Justice Black concurred specially in the *Gerhardt case* because he believed the Court should have then reconsidered the entire question of the validity of a nondiscriminatory net income tax in relation to the doctrine of reciprocal immunity.

That leaves Justices Butler, McReynolds, and Frankfurter from whom we have no authoritative expression of opinion in this class of cases. The other five Justices have already shown, however, every indication of a willingness to reconsider constitutional questions "in the light of our whole experience, and not merely in that of what was said a hundred years ago." So long as a majority of the Justices thus recognize, as Justice Holmes so aptly stated, that "what seemed to them to be first principles are believed by half of their fellow men to be wrong," the Congress is justified in affording the Court the chance to pass upon the validity of a legislative policy to terminate tax-exemption privileges by a nondiscriminatory net income tax on income "from whatever source derived."

Should Congress take that step, it may well rest assured that it is doing something fully consonant with its duty and oaths of the respective members, because, in the words of the noted historian Bancroft, "It is the Constitution which is the law and not even the past decisions of the Court upon it * * *. To the decision of an underlying question of constitutional law no * * * finality attaches. To endure it must be right."

The CHAIRMAN. Thank you, Mr. Wenchel.

I understand that completes the hearings, and I declare the hearings officially closed

As I have the situation, Senator Byrd, it will be necessary for us to make a preliminary report to the Committee on Finance, when it considers the salary tax bill which has passed the House.

We will go into session next week and endeavor to get out a report by the first of March, which we hope to make comprehensive, setting forth the views of the committee, and I do not think we can look for unanimity of opinion as I think there will be some differences between us. I think it quite probable we will want to call into executive session representatives of the proponents and the opposition.

I want to thank every one for their presentations, which have been most illuminating to me and to the rest of the committee.

(Thereupon at 12 noon, the hearings were closed and the committee adjourned.)

(Subsequently the following letter addressed to Mr. Austin J. Tobin, secretary, Conference on State Defense, by Dr. Harley L. Lutz, professor of public finance, Princeton University, was ordered printed in the record by the chairman:)

FEBRUARY 18, 1939.

MR. AUSTIN J. TOBIN,
Secretary, Conference on State Defense,
New York City.

DEAR MR. TOBIN: I have just received copies of the mimeographed statements submitted to the Special Committee on the Taxation of Government Securities and Salaries, on behalf of the Treasury Department, and in the nature of a rebuttal to the case offered by the Conference on State Defense. These witnesses included Professors Williamson, Schultz, and Studenski, and Messrs. Blough, Murphy and O'Donnell of the Treasury Department.

In view of the fact that much of this testimony discussed the report which I submitted to the comptroller of the State of New York and which he, in turn, submitted to the special committee, it seems to me highly desirable and most proper that I should have some opportunity to reply to these comments and to have my reply included as a part of the official record of the hearings before the committee. I would, therefore, appreciate it if you will submit this letter to

Senator Brown, as chairman of the committee, and convey to him my request for the inclusion of this letter in the record.

I would appreciate it, also, if, when you see him, you would express to him my gratitude for the courteous, considerate and full hearing which the committee afforded me during the course of the hearings.

The rebuttal testimony of Treasury witnesses before the special Senate committee has dealt with some points in my report on the subject of the taxation of public securities. After examination of the mimeographed and typewritten memoranda presented as the formal part of this testimony, I am submitting herewith some comments on these memoranda.

It is rather surprising that, notwithstanding the keen desire of the Treasury witnesses to establish conclusions contrary to those which I reached, there should be so great a degree of general agreement on the principal questions involved. The main features of my analysis have been corroborated by the Treasury arguments. The differences between the two positions involve chiefly certain different results in cases in which the nature of the material is such as to open the way for conclusions based on differing expert opinions, and in other cases in which a different application of my techniques might produce a different result.

This agreement between Treasury witnesses and myself is especially noteworthy in the case of the three witnesses who, like myself are university professors of public finance. These witnesses were Prof. K. M. Williamson, Prof. William J. Schultz, and Prof. Paul Studenski. None of them offered material rebuttal of my statistical methods or results. Their chief basis of disagreement with me was with respect to the relative importance of progressive taxation as against other matters of the public interest, and this, as they and other witnesses said, is a matter of opinion. It is significant that even those witnesses who occupy official positions in the Treasury Department corroborate the argument of my report in its essentials, and that the differences are principally those arising from individual opinions as to the weight or the interpretation to be given to various factors in the problem.

Thus, all of us agree that the removal of tax exemption will increase the cost of borrowing, and all are agreed that the tax will produce some revenue. Great effort was expended to prove that my estimates of increased interest cost were entirely too high and that the methods which I used were throughout improper, unscientific and inadequately supported. I return presently to some of the specific criticisms of my procedure. But it is highly significant that with respect to the revenue estimates the results which I obtained through the use of methods that were condemned as erroneous and misleading, should lie well within the range of the estimates of revenue gain given by the principal Treasury witness on this subject, Mr. Al. F. O'Donnell.

For example, my estimate of the total revenue of Federal and State Governments from the taxation of public interest is \$230,000,000. Mr. O'Donnell's estimate is a range of \$179,000,000 to \$337,000,000. But Mr. O'Donnell finds that his estimate of total revenues, if computed according to my method, virtually coincides with my own, namely, \$230,000,000. My estimate of \$120,000,000 as the Federal revenue from the taxation of State and local interest is well within Mr. O'Donnell's estimated range of \$107,000,000 to \$198,000,000. My figure of \$109,000,000 as the probable Federal revenue from the taxation of Federal interest is to be compared with Mr. O'Donnell's range of \$72,000,000 to \$139,000,000.

Mr. O'Donnell correctly points out that I did not attempt a series or range of estimates such as would be obtained by assuming certain differences or variations in the conditions to be dealt with in the statistical analysis. Consequently, I do not have a range of estimates, except at that point in my report at which I introduced an estimate published by Dr. Magill, former Under Secretary of the Treasury. However, the fact that in every case touched on by the O'Donnell estimates my own result is well within his range of estimates tends to corroborate the reasonableness of my own figures, from the standpoint of the comparable Treasury analysis. In passing, it is noteworthy that the Treasury officials, during the course of their rebuttal, made no mention of Dr. Magill's estimate, though he himself had referred to it in November 1937, as a figure reached on the basis of the best information which the Treasury then had available.

The one estimate which is not covered in Mr. O'Donnell's statement is that of the interest cost to the debtor governments.

On this subject, the Treasury figures are much below my own, and the principal reason for the difference is that the Treasury witnesses have assumed that the Federal tax will have a very slight effect on the interest rates at which the States and cities will be able to borrow, once their bonds have become taxable.

Another reason for the discrepancy in interest cost estimates between the Treasury and my report is that their witness on this subject excluded about 7 billion dollars of Federal and State bonds from consideration in making the computation. That is, he excluded public securities held in sinking funds and by the United States, and one-half of the securities held in trust and investment funds.

Naturally, since there was no conflict between the Treasury estimates and my own, except with respect to the effect of the tax on interest rates, the weight of the Treasury criticism was thrown against this part of my report. The principal witness for the Treasury on this subject was Henry C. Murphy, principal economic analyst in the Division of Research and Statistics.

Mr. Murphy's target was my assumption that the Federal tax would cause an average rise of sixty one-hundredths percent in the interest rate for State and local borrowing. His procedure in attacking my results was to take a single Treasury issue, namely, the longest maturity Treasury bond, and compare its yield on a given date with the average yield of high-grade municipal bonds and of high-grade corporate bonds, respectively, on that date. From this comparison he concludes that the interest rates may be increased by one-fourth to one-half percent. But he admits a possible upper limit of sixty-five one-hundredths percent increase when the cost to the weaker communities is considered. Consequently, despite his rejection of my own figure of sixty one-hundredths, he admits the possibility of an even higher average interest cost than I have assumed. Needless to say, he offers no effective argument to indicate whether the upper or the lower limit of his assumptions is the more likely to prevail. (See his statement before the special committee of the Senate.)

As I have indicated above, he is able to report a lower estimate of total interest cost by omitting from the total of State and local bonds more than $3,000,000,000 the only explanation being a footnote indicating that this amount is held in sinking and trust funds.

In another document entitled "Comments on the estimates presented by Professor Lutz regarding the additional interest cost which would result from the removal of tax-exemption from future issues of public securities," Mr. Murphy criticizes my report for presenting tabulations comparing average yields of Federal, municipal, and corporate bonds without making use of these figures. But the figures seemed to speak so plainly for themselves as to make unnecessary a detailed exposition of their significance. However, the following comparison is offered to indicate the general relation of these bond yields in recent years:

Year	Average annual yield differential, corporate bonds, and municipal bonds	Average annual yield differential, corporate bonds, and U. S. Treasury bonds
1935	60.6	90.6
1936	60.6	77.2
1937	59.1	69.0
1938 (9 months)	61.2	83.2

Source: The tabulation in appendix B of Professor Lutz's report.

Mr. Murphy dwelt at length on the curious and abnormal variations of bond yield during the years 1931–34 as evidence that the value of the tax-exemption privilege may at times be nil. In m yreport (p. 110) the abnormality of this period for both public and private finances was expressly recognized. Mr. Murphy's conclusion respecting my estimated average yield differential is as follows:

"The accuracy of this estimate, i. e., of $113,000,000 increased interest cost to the States, depends entirely on whether the sixty one-hundredths of 1 percent differential Professor Lutz uses is reasonable. Certainly, he has not demonstrated that it is: * * *."

But, as indicated above, Mr. Murphy has used, as one extreme of his range, an even higher figure, namely, sixty-five one-hundredths of 1 percent. If he had considered the bond yield record from 1935 to 1938, instead of that for the obviously and admittedly abnormal period 1931–34, he would have found substantial support from the market record for a yield differential of sixty one-hundredths percent.

It was pointed out in my report that all of the evidence which pointed to a yield differential of 60 points or thereabouts was derived from the record of the highest grade municipal bonds. Not many of the States and cities enjoy this highest grade credit rating, and for all of the weaker units, a yield differential of greater amount would be more than likely. Since it was impossible to arrive at a graduation of these ratings, the interest cost computations were made on a basis which assumed that a yield differential of 60 points would be a fair average.

Mr. Murphy also contends that State taxation of Federal interest could have no effect on Federal interest cost, for the following reason:

"* * * the purchasers in non-income-tax States now derive the least benefit taxwise from the State tax exemption on Federal securities—that is, no benefit at all—and they accordingly set the price for such securities, the price they are willing to pay, making no allowance for the exemption from State income taxes."

The rebuttal in this, and in similar instances, is based on a stilted academic approach: Mr. Murphy finds it necessary to assume, in support of this approach, that the investors in income-tax States are unable to buy more Federal bonds, and hence that subsequent issues must be sold in the non-income-tax States. Thus, by assuming that the non-income-tax States constitute the only available market, he proves that these States determine the price of all Federal securities.

The assumption of an absolute limit of capacity to absorb public securities in any State or group of States is obviously weak. The assumption that the investors in the non-income-tax States actually set the prices for Federal securities is particularly weak when the list of such States is recalled. Outside of three States, Illinois, Michigan, and New Jersey, where there is a considerable concentration of wealth, the list of non-income-tax States includes Florida, Maine, Nebraska, Nevada, Washington, and Wyoming. The investing power in such States is clearly of no great importance in determining the market prices of Federal securities.

Even so, investors in these States could not afford to disregard the prevailing prices of public securities, were tax exemption to be eliminated, for they would face the possibility of a State income tax at some future time and hence they would be obliged, in self-defense, to discount the possible effects of such a tax, just as the investors in the income-tax States would be obliged to discount the effects of the current State income tax.

In computing the effects of the Federal tax on Federal interest cost, Mr. Murphy accepts my methods but contends that they were improperly used. The alleged error was in giving weight to the attitude of corporate investors, to whom all Federal debt is now wholly tax-exempt. He holds that the only investors to be considered are those individuals who now own partially exempt securities, and who would be required, therefore, to pay only 4 percent normal tax additional.

In other words, Mr. Murphy contends that corporate investors who now buy Treasury bonds on, say, a 2.40-percent yield basis without a tax, will be willing, after the tax exemption is removed, to buy and hold such securities on the same yield basis, although they would then be obliged to pay at least 16½ percent of this interest return in Federal tax.

Stated thus, the issue seems to me to be capable of only one answer. It is that the corporate investors will make an effort to readjust the yield basis so as to shift as much of the tax as possible to the debtor governments.

In fact, individual investors will do the same, and hence it is not possible to limit the calculation of interest increase simply to the effect of the 4 percent normal tax. The removal of the exemption will mean a completely new deal in ownership distribution, in bond valuations, and in yield bases. Under this new deal will emerge a new scale of prices and yields which will be a composite of all investor attitudes and appraisals. With the reshuffling that will occur, there is nothing advanced or suggested by the Treasury witnesses to provide assurance that any present holder of Federal partially exempt securities will make no greater effort to shift the tax than is measured, relatively, by the normal tax rate of 4 percent.

My conclusion that the yield differential on Federal bonds would be increased 50 points, or one-half percent, is conservative in view of the yield spread between corporate and Treasury bonds, given above, and it is no higher than the upper limit of the range of increases suggested by the Treasury witnesses themselves.

A third witness for the Treasury Department was Mr. Roy Blough, Director of Tax Research. Mr. Blough's statement to the committee dealt mainly with two matters in my report, one was the question of progressive taxation, the other was the effect of the Federal tax on local taxpayers.

With regard to progressive taxation, Mr. Blough admits that it is a matter of opinion. His principal concern in dealing with this topic was to create an impression to the effect that the amount of tax avoidance through tax-exempt securities is vastly greater than I had indicated. To do this, he stresses the point, made in my report, that the advantage from owning tax-exempt securities depends on the yield differential, and that under certain conditions some advantage might appear for those with net incomes as low as $18,000 to $20,000.

Now it is clear that so far as any great advantage from the ownership of tax-exempt securities is concerned, it is enjoyed only by those with incomes materially above $20,000, or even above $35,000. My statement of the case, which emphasized the situation for those with incomes of $60,000 and over, was correct for the purpose of emphasizing the group which might enjoy a large positive advantage from such ownership. In my report I suggested that while a person with an income of from $20,000 to $50,000 might derive some advantage, it could not be a material gain in any individual case, as the amount of net income involved is too small.

But Mr. Blough, striving for effect, wrote the following:

"It is submitted that existence of some 100,000 taxpayers, who reported about $4,000,000,000 of net income or more than one-fourth of the total income reported on individual income tax returns, and are in position to gain by tax exemption—and have gained an undetermined amount—constitutes a serious threat to the progressiveness of the income tax."

While he carefully refrained from saying it, he evidently hoped to convey the suggestion, or to create the impression, that the receipt of $4,000,000,000 of taxable income by some 100,000 persons indicated also the receipt of a huge amount of tax-exempt income. Aside from this insinuation, the paragraph just quoted completely defeats the purpose. What Mr. Blough says here is that the receipt of $4,000,000,000 of taxable income by 100,000 persons constitutes a serious threat to the progressiveness of the income tax.

Nothing could be wider of the mark. If we take those taxpayers with net incomes of $20,000 and over, in order to avoid interpolation of the published income-tax statistics, we find the following as of 1936:

Classes of taxpayers	Number of returns	Net income in 1936	Tax in 1936
All individuals	5,413,499	$10,240,000,000	$1,214,000,000
Individuals with net income of $20,000 and over	84,565	3,847,000,000	949,276,000
Percentage of those with net income of $20,000 and over	1.57	20.0	78.2

Thus, we find that Mr. Blough's evidence of the disintegration of progressive income taxation boils down to the following: 1.57 percent of all persons making a tax return in 1926 had a net income of $20,000 and over for the year; these persons reported 20 percent of all net income and paid 78.2 percent of the total income tax collected from individuals. This is not a very convincing demonstration of the break-down of progressive taxation.

Furthermore, Mr. Blough admits that the amount of tax-exempt income which may have been received by these persons is not a determined amount. He passes over the evidence of the estate-tax records, which indicates that persons with large means do not, in general, derive a large part of their income from Federal or State securities. Yet, in face of the proportion of all individual income taxes which is paid by some 1.5 percent of the income tax payers, he would persuade the committee that such income as these persons may receive from Federal or State securities proves the collapse of progressive income taxation.

Mr. Blough also stated that with a yield differential of sixty one-hundredths percent individual investors might expect to gain from tax exemption only beyond the net income level of $35,000. There were, in 1936, approximately 35,000 persons with net incomes above this amount. This is considerably less than the 100,000 persons whom he preferred to emphasize as possible beneficiaries from tax exemption.

Mr. Blough next attacks my suggestion that the present situation benefits small-property taxpayers who pay less in taxes to support the public debt by reason of the tax-exemption and tax-immunity situation. He paraphrases my statement of this diffusion of the benefits of the exemption policy in the following words:

"Thus, everyone gains; persons with large incomes, persons with small incomes, and government. The efforts of persons in the higher-income brackets to avoid income taxation thus take on a degree of nobility which has not heretofore been suspected."

Having written this, Mr. Blough's desire to be a clever led him to add the following:

"From sheer logic alone [sic] Professor Lutz' argument that everyone gains appears to be bootstrap economics at its best."

This comment implies that if more than one party benefits in an economic transaction it is bootstrap economics. It is accepted as fundamental in economics that both parties may gain in any fair trade. Each party gets something of greater value to him, in such a trade, than the thing he surrendered in exchange for it. Yet Mr. Blough would say that this view is bootstrap economics.

My argument regarding the benefits of tax exemption, to which Mr. Blough dissents in not too-well considered terms, is that these benefits are not limited to the few high-income persons who may pay somewhat less income tax. They are diffused among all who must pay taxes to support public debts, since the interest costs of these debts are lower than they would be if investors were fully taxed thereon.

This position should be attacked by something stronger than ridicule.

Mr. Blough's only further contribution on the subject is to repeat the figures given by Mr. Hanes and to assert the general reliability of the Treasury experts' calculations. With respect to those calculations, it should be noted that in addition to using abnormally low yield differentials to measure the effect of the tax, they excluded some $7,000,000,000 of public debt in computing the total increase of interest cost; that is, they did not include the amount of public securities held in sinking funds and by the Federal Government, and they included only one-half of the securities held in trust and investment funds. (See table II, at the end of the statement by Henry C. Murphy.)

Mr. Blough develops the same inconsistency into which Mr. Hanes fell, as I have pointed out in appendix H of my report. It is that of denying that the tax will cause any appreciable rise of interest costs, and of stressing, at the same time, the losses which various small-income groups suffer because of the exemption. Mr. Blough speaks of the low-income yield received by insurance companies from their investments in public securities, leading to higher insurance premiums; he mentions the savings banks, which must pay lower rates on savings deposits because of this low yield; he refers to the diminished earnings of endowments and of public trust funds, which must therefore lower their payments to beneficiaries.

If the Treasury witnesses are correct in their contention that interest rates will rise in only negligible degree, Mr. Blough and Mr. Hanes are wrong in telling the small-income groups that the elimination of tax exemption will increase savings-bank interest rates, reduce insurance company premiums, and enable pension funds to pay larger pensions. They are also wrong in saying that after the removal of tax exemption the small-income groups can afford to buy the public securities. Mr. Blough has said that his yield figures show that individuals with moderate means cannot now avail themselves of investments in public securities. But if the yield of these securities is to improve by no more than the Treasury witnesses have asserted, why hold out that small investors will find these securities materially more attractive after they have been made taxable?

The Treasury witnesses have been trying to run with the fox and hunt with the hounds. They deny any material increase of interest rates, in an attempt to prove the fiscal advantage of the scheme; but they also seek to establish popular support for it by holding out promises of material benefits to various small-income groups through the enhanced income receipts of banks, insurance companies, and pension funds, after the public securities have been made taxable. Mr. Blough's argument turns against him at this point, for it reads very much like saying that something can be got for nothing. Substantial benefits to the investors in public securities can be obtained only by substantial increase of interest rates.

In this connection, attention is directed to Mr. Murphy's observation that Mr. Kerschner, secretary of the Ohio teachers' retirement system, was appearing against the interests of his constituents rather than for them. He added:

"* * * it is certainly to the interest of the teachers who are members of the Ohio State teachers' retirement system that they should receive the full standard rate of interest on the funds invested on their behalf rather than a rate artificially depressed by exemption from a tax to which the fund would not be subject in any event." (See his statement.)

Considering the vigor with which Mr. Murphy has contended, elsewhere in his statement, that the interest rates and yield basis of public securities would hardly be affected at all by the removal of tax exemption, it is highly interesting, and significant, to find him here saying that tax exemption produces an artificially depressed interest rate, and implying that the removal of that exemption would result in substantial gains to the Ohio teachers who receive pensions from the State retirement fund.

Mr. Blough's second main point in criticism of my report is that the effects of the taxation of public securities would be much less severe upon local taxpayers than I had suggested. In order to show this, he uses the Treasury's low estimates of the effect on interest cost (one-fourth of 1 percent), and he expresses the results in per capita terms, pointing out that my estimate of the increased burden of State and local interest would eventually produce a property tax increase of only \$0.84 per capita. Such a basis of comparison may be more soothing to the local taxpayer than one expressed in terms of the tax rate, but it does not meet or dispose of the real issue.

A further objection to my procedure is that I failed to differentiate between general obligation bonds, supported directly by local tax levies, and various special debts such as those created to finance special assessment improvements and municipal utilities.

This is a matter of procedure, criticism of which is proper, although it does not seriously affect the general result. Special assessment bonds are supported, normally, by special levies on the property affected by a local improvement. If such bonds are made taxable the assessments must be increased. In the case of municipal utilities, the effect of the tax would be to increase the rates for the services supplied by those utilities. Since many kinds of municipal undertakings are not actually self-supporting, it would require elaborate analyses to determine the cases in which the effect of the tax would be to produce an increase of service charges as against the cases in which it would lead to higher general tax levies. In some States only a part of the cost of local improvements is met by so-called special assessments, and in some instances, too, special assessment bonds are supported by the general faith and credit of the municipality in case of defaulted assessments.

Mr. Blough's criticism implies that I should have assorted all of these cases in order to show just what part of the increased interest cost would have fallen on the users of municipal utility services and on those who are liable for special assessments, as against that part of the cost which would fall on those who must pay local general property taxes. As I have pointed out, some part of the cost of bonds for special improvements and for municipal utilities does now fall on the general taxpayer. Just what part no one knows. It is very doubtful if anyone could ascertain the correct apportionment, for all local units. Mr. Blough has really criticized me, therefore, for not undertaking the impossible.

Mr. Blough did not attempt it either. Instead, he elected to disregard the effects of all other local debt costs except those which he could assign to the local property tax levy. Thus, he obtains calculations of the burdens of the Federal tax upon local taxpayers which are far below what must be borne by them in one form or another.

Finally, may I say again that it is highly significant to find such substantial corroboration of my findings by the testimony of the Treasury witnesses, and particularly by that of the three independent professors of public finance. These witnesses were seeking to overthrow the report, but they have really provided support for its most essential conclusions.

Very truly yours,

HARLEY L. LUTZ.

(Subsequently the following memorandum submitted to the chairman by the staff of the Joint Committee on Internal Revenue Taxation was ordered printed in the record:)

MEMORANDUM FROM THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION IN ANSWER TO REMARKS OF JOHN PHILIP WENCHEL, CHIEF COUNSEL, BUREAU OF INTERNAL REVENUE, CRITICIZING REPORT OF STAFF

1. The Chief Counsel for the Bureau of Internal Revenue criticizes the report of the staff of the joint committee in giving effect only to the majority opinions of the Supreme Court and not to the dissenting opinions. Of course, in determining what the law actually is as to any constitutional question, the decision of the majority must control and not the minority.

2. The Chief Counsel states that the staff report treats too cavalierly the reasoning of the Court in *Weston* v. *Charleston* as reflected by the opinion of the dissenting judges. However, the report reaches its conclusion not on the basis of the statements of the dissenting Justices but on the basis of the majority view. That the majority view held this tax to be an income tax and not a property tax,

was emphasized by Mr. Justice Fuller in writing the majority opinion in the *Pollock case* and by Mr. Justice Cardozo in writing the majority opinion in *Hale* v. *State Board of Assessment and Review*.

3. The Chief Counsel for the Bureau of Internal Revenue states that the report ignores the basic reasoning of the Court in the second *Pollock case*. Yet, the report actually quotes from the decision of the Court in that case, holding that—

"We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution."

4. The Chief Counsel for the Bureau of Internal Revenue insists that the case of *Cohn* v. *Graves* ((1937), 300 U. S. 308), in effect, overrules the doctrine upon which he contends that the decision in the *Pollock case* was based. That is, the *Pollock case* declared a tax on the income from bonds to be a tax on the bonds themselves, while in the *Cohn case* the Court upheld a New York income tax upon rents received by a resident of New York from a real estate lying in New Jersey. The report makes it clear that the portion of the *Pollock case* dealing with the interest of governmental securities rested on fact that to tax such interest, directly or indirectly, hampered the power of the States to borrow money and was, consequently, repugnant to the Constitution. He fails to give any effect to the majority opinion by Mr. Justice Stone clearly distinguishing the *Cohn case* from the *Pollock case* or to the majority opinion of Mr. Justice Cardozo in the case of *Hale* v. *State Board*. In this connection, the following is quoted from pages 17 and 18 of the report:

"(H) COHN V. GRAVES

"The reasoning of the *Pollock case* has not been rejected in the above-cited case. In that case, the Court held that the State of New York may tax her citizen upon income he received from land situated in another State and from interest on bonds secured by a mortgage on land situated in another State. It was stated that the incidence of a tax on income differs from a tax on property. Neither tax being dependent upon the possession by the taxpayer of the subject of the other.

"The *Pollock case* was distinguished from this situation as follows:

" 'Nothing which was said or decided in *Pollock* v. *Farmers Loan & Trust Co.* (157 U. S. 429) calls for a different conclusion. There the question for decision was whether a Federal tax on income derived from rents of land is a direct tax requiring apportionment under article I, section 2, clause 3, of the Constitution. In holding that the tax was "direct," the Court did not rest its decision upon the ground that the tax was a tax on the land, or that it was subject to every limitation which the Constitution imposes on property taxes. It determined only that for purposes of apportionment there were similarities in the operation of the two kinds of tax which made it appropriate to classify both as direct, and within the constitutional command. (See *Pollock* v. *Farmers Loan & Trust Co., supra*, pp. 580, 581; *Brushaber* v. *Union Pacific R. Co.* (240 U. S. 1, 16).) And in *Union Transit Refrigerator Co.* v. *Kentucky* (199 U. S. 194, 204), decided 10 years after the *Pollock case*, the present question was thought not to be foreclosed.

" 'It is by a parity of reasoning that the immunity of income-producing instrumentalities of one government, State or National, from taxation by the other, has been extended to the income. It was thought that the tax, whether on the instrumentality or on the income produced by it, would equally burden the operations of government. (See *Collector* v. *Day* (11 Wall. 113, 124); *Pollock* v. *Farmers Loan & Trust Co., supra*, 583; *Gillespie* v. *Oklahoma* (257 U. S. 501).) But as we have seen, it does not follow that a tax on land and a tax on income derived from it are identical in their incidence or rest upon the same basis of taxing power, which are controlling factors in determining whether either tax infringes due process.'

"(I) HALE *v.* STATE BOARD

"Nothing in the above-mentioned case is in conflict with the *Pollock case*. In that case, Iowa enacted a law exempting its municipal and State bonds from taxation. Subsequently, it passed for the first time a tax on the net income of residents in the State, and the interest derived from such bonds was included in an assessment made against the bondholders. The State court interpreted the exemption from taxation as only applying to taxes laid on property in proportion to its value, and not as touching taxes in the nature of an excise upon net income of the owner. The Supreme Court in an opinion by Mr. Justice Cardozo, upheld the tax, stating:

"'* * * *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429; 158 U. S. 601), was considered and distinguished. Two rulings emerge as a result of the analysis. By the teaching of the *Pollock case* an income tax on the rents of land (157 U. S. 429) or even on the fruits of other investments (158 U. S. 601) is an impost upon property within the section of the Constitution (art. I, sec. 2, clause 3) governing the apportionment of direct taxes among the States (300 U. S., at p. 315). By the teaching of the same case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland* (4 Wheat. 316) and *Collector* v. *Day* (11 Wall. 113, 124; 300 U. S., at pp. 315, 316). There was no holding that the tax is a property one for every purpose or in every context. We look to all the facts.

"'In line with that conception of the *Pollock case* is *Brushaber* v. *Union Pacific R. Co., supra*, where the Court pointed out (240 U. S., at pp. 16, 17) that "the conclusion reached in the *Pollock case* did not in any degree involve holding that income taxes generically and necessarily came within the class of direct taxes on property," but that to the contrary, such taxes were enforcible as excises except to the extent that violence might thus be done to the spirit and intent of the rule governing apportionment.

"'* * * Nothing in this opinion is at war with *Weston* v. *Charleston* (2 Pet. 449), or other cases declaring the immunities of governmental agencies. In the case cited and its congeners the problem for decision was whether a tax upon income, even though not a property tax in strictness or for every purpose, was one in such a sense or in such a measure as to hamper the freedom of the Central Government through the interference of the States or the freedom of the States through the interference of the Central Government. The limitations declared in those decisions were gathered by implication from the structure of our Federal system, and were accomodated, as the Court believed, to the public policy at stake. What the Court is now concerned with, however, is not the preservation or protection of any governmental function. Iowa cannot be held to cripple in an unconstitutional way her own privileges and powers when she levies an income or even a property tax upon bonds issued by herself. The Court is now concerned with the meaning and effect of particular contracts of exemption to be read narrowly and strictly. There is no room at such a time for the freer and broader methods that have been thought to be appropriate in the development of the doctrine of implied restraints.'"

Yet, in spite of these opinions of the majority, the Chief counsel for the Bureau of Internal Revenue would have us believe that the *Pollock cases* were overruled because of a dissenting opinion by two of the Justices in the *Cohn case*.

(5) The Chief Counsel refers to the *Dravo case* (302 U. S. 134), the *Mountain Producers Case* (303 U. S. 376), and *Alen* v. *Regents* (304 U. S. 439). These cases are all dealt with in the report on pages 18, 19, and 20 and distinguished.

6. The Chief Counsel for the Bureau of Internal Revenue cites the *R. J. Reynolds Tobacco Company case*, as of January 30 of this year, to overcome the contention of the staff that the definition of gross income in the present revenue acts is broad enough to cover the compensation of State officers and employees. The question in that case was whether a corporation realized any taxable gain from the purchase or sale of its own stock. In 1934, the Treasury amended its regulation by treating such increment as income and tried to apply the regulation retroactively to 1929, although the regulation in force in 1929, when the transaction was consummated, did not tax such. The Court stated that the question of whether the increment was income was at least a debatable issue, and, therefore, the regulation was a proper interpretation of the meaning of the law. Since this construction had been uniform under successive revenue acts containing, without alteration, the same definition of gross income, the Court held that Congress must be understood to have approved the administrative construction and to have given it the force of law. But the regulations dealing with State employees have not been uniform, as shown on page 38 of the report.

First, the Treasury Regulations exempted all State officers and employees; then they exempted only those engaged in essential governmental functions; and now they tax all State officers and employees to the extent not immune from taxation under the Constitution. And Mr. Justice Stone in the majority opinion in the *Gerhardt case* stated in referring to the provisions of the 1932 act that they "do not authorize the exclusion from gross income of the salaries of employees of a State or a State-owned corporation." So it is not a debatable issue as to whether the language of the present statute is broad enough to cover the compensation of State officers and employees.

7. The Chief Counsel for the Bureau states that the genesis of the phrase "from whatever source derived" was omitted from the part of the report dealing with the interpretation of the sixteenth amendment. To support this statement, he refers

to language used in the Civil War Acts, the act of 1894, and the Corporation Excise Tax Act of 1909. But the language under these acts is different from the language of the sixteenth amendment, and there is nothing in the debates under the sixteenth amendment to show that the language used in the sixteenth amendment was derived from those acts.

The argument in *Collector* v. *Day* was whether the term "salaries" as used in that act embraced the salary of a State judge. There was no construction of the phrase "from any other source whatever." The Court in that case did not hold that any provision of the Civil War Act was unconstitutional. It can be argued from a reading of that case that Congress did not intend the language to apply to the salary of a State officer if it interfered with the sovereignty of a State. See Senator Borah's reply to Senator Hughes which was referred to by the Supreme Court in *Evans* v. *Gore*. The act of 1894 taxed the interest upon "bonds, and other securities, except bonds of the United States, the principal and interest of which are by the law of their issuance exempt from all Federal taxation." It will be noted that a sovereign was specifically mentioned, namely, the United States, in this section. There was no determination that the phrase "or from any source whatever," which was used in connection with other items of income, was intended to apply to the interest from State and local bonds. The express exemption of the compensation of State and local officers in the 1894 act appears only with respect to the 2 percent pay tax withheld at the source. The exemption from the general income tax taxing income from all sources must have been implied as a result of *Collector* v. *Day*. Compare section 27 of the act of 1894 taxing dividends, salaries, and "income from any other source whatever" and which did not contain any exemption to State officers and employees with section 33 of that act imposing a tax on officers and employees of the United States which contains a proviso "*Provided*, That salaries due to State, county, or municipal officers shall be exempt from the income tax herein levied." The act of 1909, in levying an excise tax, measured the tax by income from "all sources." While this language was held broad enough to include interest from State bonds in the *Flint* v. *Stone Tracy case*, that decision was not decided until after the sixteenth amendment had already passed the Congress and after 25 States had ratified it. Therefore, it cannot be held that the language of the 1909 act, which was not construed by the Court, until this late date, could be the genesis of the meaning of the sixteenth amendment. Thomas E. Powell, writing in National Income Tax Magazine, 1923 stated:

"It was in the *Pollock case* that the Supreme Court squarely held that the Federal Government cannot tax the interest paid on State and municipal bonds. It may be criticized, but it still stands as the law. It is unfair to ask the States to give up the bounty they now enjoy unless they in turn receive some guarantee that the Federal Government will also yield its reciprocal bounty. No single Congress can give to the States the firm assurance they would find in a constitutional amendment. Had the sixteenth amendment been interpreted literally, the States would have lost their bounty and would still be required to confer a bounty on the Nation. A court might well pause before sanctioning such a result (Thomas E. Powell, National Income Tax Magazine, 1923)."

8. Because the Court has permitted us through an excise or privilege tax to include in the measure of the tax the income from State and local bonds, the Chief Counsel for the Bureau concludes that we may disregard the excise or privilege entirely and tax such income directly. He fails to see that the Court has also permitted us through an excise or privilege tax to include the bonds themselves as a measure of the tax. If his theory is sound and is followed to its logical conclusion, we could disregard the excise or privilege entirely and tax the bonds directly. The answer is, of course, that the Court in all of its majority opinions has consistently repudiated such a theory. See pages 13 and 14 of the staff report. He finds support for his view only in one dissenting opinion in the *National Life case*.

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