Statement of Randolph E. Paul,
Tax Adviser to the Secretary of the Treasury,
Before the Ways and Means Committee
of the House of Representatives
on tax-exempt securities

April 16, 1942

I. THE ECONOMIC ISSUES

In his statement to your Committee on March 3, 1942, the Secretary of the Treasury recommended the taxation of interest from outstanding, as well as future, issues of State and local securities. I should like now to discuss this recommendation more fully and to present supporting evidence. 1/

The present war emergency makes the immediate elimination of tax-exempt securities an important step in sound war finance. Under war conditions, the withdrawal of the tax immunity from future issues alone will not be enough. What is required now is the immediate removal of tax exemption in all cases in which the Federal Government is not bound by its own pledge.

1. The revenue loss from tax exemption is substantial

The annual loss in revenue from the tax exemption of State and local securities under the rates proposed by the Treasury is estimated at $275 million 2/, at 1942 levels of business.

2. The revenue loss from tax exemption will continue to increase

This is a large amount; but the continuance of the existing tax exemption would not stabilize the revenue loss even at that large figure. If the tax exemption were removed only from future issues, a considerably larger revenue loss could result merely from the shifting of outstanding issues from holders subject to little or no income taxes to those subject to higher rates.

Of the $20 billion of such securities outstanding on June 30, 1941, $12.2 billions were held by tax-exempt institutions, governments, banks, insurance companies and, to a small extent, other business corporations. (Table 1 & Chart 1) The securities of these holders are a huge reservoir from which individuals could increase their tax-free holdings by as much as 150 percent, even if the tax exemption privilege were immediately removed from all new issues. Additional shifts are possible from individuals in low income groups to individuals in high income groups.

1/ Some of the detailed evidence is supplied in appendices.

2/ At present rates the loss is estimated at $184 million.

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All such transfers of outstanding tax exempts to individuals with large incomes yield nothing by way of lower interest rates to State or local governments. The benefits of such transfers are confined mainly to the sellers, who obtain windfall capital gains, and to the buyers who obtain exemption from regular and wartime income taxes.

3. Tax rate increases stimulate tax avoidance

Even before 1941, the trend toward the concentration of tax-exempt securities in the hands of individuals in the upper income brackets had become noticeable. State and local securities have constituted an increasing percentage of the total assets of large estates, and there has been a pronounced and consistent tendency for tax-exempt securities to constitute a greater percentage of the larger than of the smaller estates. For net estates of $1,100,000 and over, State and local securities averaged 6.2 percent of the gross estate in 1928 and 15.1 percent in 1940. (Table 2 and Chart 2)

We may reasonably expect a further increase in the movement of tax-exempt securities into the hands of those with large incomes because the recent and anticipated tax rate increases provide new and powerful motives to individuals with large incomes to use this means of tax avoidance. Under the 1942 tax rates proposed by the Treasury, an individual with a surtax net income of $100,000 from other sources would obtain as large a net return, after taxes, from a $2\frac{1}{2}$ percent municipal bond as from a taxable investment yielding 20.8 percent. Other illustrations are presented in Table 3.

4. The outstanding tax-exempt securities were not purchased in anticipation of war-time tax rates

The continuance of the tax exemption of interest on State and local securities enables the holders of these securities to avoid not only the pre-war scale of income taxes, but also the tax rate increases necessitated by the war. Most of the outstanding bonds were issued long before there could have been any serious expectation of war-time tax rates. Of the $20 billions of State and local securities outstanding, $14.4 billions, or almost three-quarters of the total, has been outstanding for five years or more, and $10.7 billions, or over half the total, for ten years or more. (Table 4)

Tax exemption enables the holders of State and local securities to enjoy an exemption for which few, if any, can be said to have paid a price at all commensurate with the benefits received. Insofar as the coupon rates of interest and the market prices of State and local securities reflected the tax exemption privilege at all, they reflected exemption from much lower tax rates than those in prospect, and, in most cases, than those already in force. A person with income from other sources of $100,000, who purchased a 4 percent tax-exempt security in 1929, obtained therefrom the equivalent of a taxable return of 5.26 percent under 1929 rates. Under the rates proposed by the Treasury this individual would derive as much benefit from his 4 percent tax-free bond as he would from a taxable security yielding 33 1/3 percent. (Table 5)

5. Holders of tax-exempt securities have enjoyed substantial windfalls during recent years

Because of the rise in tax rates, and also because of the decline in interest rates, most holders of tax-exempt securities have enjoyed substantial windfalls during recent years. The most common rates of interest on State and municipal bonds now outstanding are 4 to 4½ percent, whereas the present market yield of such securities is generally below 3 percent. (Table 6 and Chart 3) For 1941 the average coupon rate on all outstanding State and local government securities was just over 4 percent, while the Standard Statistics Company's index of municipal bond yields for April, 1942, was only 2.49 percent.

6. Tax exemption results in inequitable taxation

Tax-exempt securities produce sharp inequalities in tax burdens. Persons with income from property are in a position to benefit most from this means of tax avoidance; persons who derive their incomes from earnings benefit least. Every increase in tax rates increases the importance of these inequalities.

The discrimination between individuals and between classes of individuals constitutes, from an equitable standpoint, the most fundamental of all the objections to tax-exempt securities. A survey of twenty-five actual returns for the taxable year 1940 reveals how striking are the differences in burden resulting from tax-exempt securities. If the rate schedule proposed by the Treasury were applied to the tax-exempt, as well as the taxable, income reported on these returns, the aggregate tax liability would be almost doubled -- $21.4 million, instead of $12.5 million. Several of the cases summarized in Table 7 are spectacular. In one case, out of a total reported income of approximately $974,600, no less than $668,700 came from State and local securities. The tax liability under the proposed rates would be $254,300, if the tax-exemption privilege were retained, but $856,100, if the tax-exemption privilege were removed. In a second case, $817,400 out of a total income of $1,106,300 was in the form of State and local interest. The tax liability of $239,600 under proposed rates would be raised to $975,300 if the entire income were taxable.

7. The premium paid for tax-exempt securities does not reflect the value of the tax exemption

The differences between taxes paid by recipients of taxable and tax-exempt income would be less inequitable if the holders of tax-exempt securities had paid a premium that reflected in full the value of the tax exemption. This is not the case. The price that is set upon the tax-exemption privilege in the open market differs substantially in most cases, and spectacularly in the extreme cases, from the value of the exemption privilege to the individual purchaser. The current market value of the tax-exemption feature of State and local securities is roughly, 1/2 of 1 percent. This means that an investor who purchases a municipal bond must content himself with a yield that is about 1/2 of 1 percent lower, before allowance for taxes, than the yield he could obtain from a corporate bond of comparable quality. But to an individual with a surtax net income of $150,000, under the rates proposed by the Treasury, the tax-exemption feature of the municipal bond is worth five times as much as he has to pay for it. A high grade 3 percent corporation bond purchased at par would yield him only 3/10 of 1 percent after income taxes, compared with the $2\frac{1}{2}$ percent tax-free yield that he could get from a municipal bond of at least comparable quality. The investor pays a half percent. It would be worth his while to pay as much as 2.7 percent.

The value of the tax-exemption privilege varies with the size of individual incomes. To a person with an income below the personal exemption, a 3 percent tax-free security is worth no more than a taxable security of comparable cost. To a married man with no dependents, with a net income of $10,000, the same 3 percent tax-free security is equivalent, under the proposed rates, to a taxable issue yielding 4.84 percent. To a similar individual with a net income of $100,000, the 3 percent tax-free security is equivalent to a taxable security yielding 25.0 percent; and to an individual with a taxable income of half a million dollars, to a taxable security yielding 30 percent. (Table 3)

If the volume of State and local securities were so small that the whole amount available was purchased by individuals in the upper income brackets, the premium paid for these securities in the form of lower interest rates might reflect roughly the value of the tax exemption to the purchasers. However, the larger part of the outstanding securities was held by Federal and State trust funds, banks, insurance companies, and other corporations. (Table 1) Some of these institutional investors enjoy a tax-free status. To them the tax exemption feature has no value at all. Others are subject to effective rates of taxation much lower than the rates imposed on income received by individuals in the upper income brackets. Normally, the price paid for a privilege of this sort in the open market will reflect the importance of that privilege, not to the most urgent, but to the least urgent of the actual buyers. That is to say, the premium paid for the tax-exempt security will reflect the importance of the exemption privilege to those among the buyers to whom the privilege is worth the least.

Purchases to avoid taxes are not the only factors affecting the yield of State and local securities. Some investors, because of legal requirements, their desire for greater safety, or ignorance of superior alternatives, purchase or retain State and local securities even at some sacrifice in interest rates and without any regard to the tax exemption. Many wealthy individuals do not choose their investments solely with an eye on net yields after taxes. They are also influenced by the desire to control particular business enterprises, and reluctance to alter radically the composition of large bequests or other large holdings, particularly when such an alteration would entail the liquidation of properties with poor markets.

The net balance of these factors has been such that wealthy individuals have consistently been able to purchase tax exemption at bargain prices. This fact is reflected in Tables 8 and 9 and Charts 4 and 5, which show the spread in yield between corporate and municipal bonds is small relative to possible tax benefits.

8. <u>The removal of the tax exemption will not reduce State and local sovereignty</u>

The claim is frequently made that the removal of tax exemption would undermine State and local sovereignty. Some persons have argued as if the adoption of this proposal would give the Federal Government the power to levy <u>special</u> or <u>discriminatory</u> taxes upon any or all operations of State and local governments. Nothing could be further from the truth. The elimination of tax exemption would not give the Federal Government the right to tax State and local interest at rates any higher than apply to other forms of income. It would give the Federal Government no new powers over the operations of State and local governments.

The securities of local governments in Great Britain do not enjoy exemption from the income tax of the central government, nor do those of the local governments and provinces of Canada or Australia. Further, in subjecting interest from State and local securities to the same tax laws that apply to other kinds of income, the Federal Government would only be doing what all of the thirty-two States imposing personal income taxes already do themselves with respect to the obligations of other States and the subdivisions thereof. (Table 10)

9. Elimination of tax exemption would only moderately increase State and local interest costs

The removal of tax exemption is frequently opposed on the ground that it would greatly increase State and local interest costs. These fears appear to be exaggerated. Tax exemption is only one of the many influences affecting the market rate of interest for State and local securities. Some persons mistakenly ascribe the whole difference between corporate and municipal bond yields to the tax exemption privilege. But a large part of the difference is due to the superior quality or greater safety of State and local obligations. The differential in yield in favor of municipal bonds was greater in 1900, before the adoption of the Federal income tax, than it is today. (Table 9)

Although the precise effect of the tax-exemption privilege on the market interest rate is subject to some difference of opinion, the Treasury believes that it is somewhere between one-fourth and five-eighths of one percent. Hence, it is reasonable to suppose that the removal of the tax-exemption privilege would increase interest rates on new State and local issues by something less than one-half of one percent on the average.

The interest costs of outstanding obligations would not be affected unless and until the obligations were refunded by new issues. It will be 1970 before 90 percent of the outstanding State and local obligations have matured. 1/ (Table 11)

1/ The fact that new plus-refunding issues have been appearing at the rate of a billion a year must not be made the basis for the expectation that the entire outstanding debt will have been refunded in twenty years. A portion of the refunding issues merely replace securities which in themselves were refunding issues.

If other interest rates remained at approximately their present levels, the refunding of outstanding tax-exempt obligations with taxable securities would not increase the interest costs of State and local governments in the vast majority of cases since the removal of the tax exemption would be more than offset by the drastic decline that has taken place in the general level of interest rates.

In recent years new and refunding State and local issues have averaged about $1 billion annually. If this volume should continue, the immediate effect of the elimination of the tax immunity would be an increase in State and local interest costs of about $5 million during the first year. Eventually, the annual difference would reach about $100 millions if the debt of State and local governments remained at its recent level.

The net cost to State and local governments would be less than $100 million, since they would obtain increased revenues from the application of their income taxes to new Federal issues, if Congress consents to such taxation.

10. <u>Tax exemption should be appraised as a joint Federal, State, and local problem</u>

The individual citizen is not only a citizen and taxpayer of his city and State; he is no less a citizen and taxpayer of his national government. He is subject at one and the same time to taxes imposed by all governments, -- Federal, State, and local. The additional burden imposed on the State and local governments must be balanced against the new revenue that would be derived from Federal taxation. The net burden on the taxpayers of the Nation as a whole will not be increased by the removal of the exemption privilege. Whereas the immediate difference in interest costs to State and local governments would be about $5 million a year and the ultimate difference in the neighborhood of $100 million a year, the Federal Government would, under the proposed rates for 1942, avoid an immediate annual loss in revenue of $275 million and the possibility of even larger future losses in revenue. Finally, the taxpayers of the nation as a whole would be benefited by the elimination of an important source of tax avoidance, and by a resulting increase in the equity with which the total tax load is distributed among our citizens.

II. THE LEGAL AND CONSTITUTIONAL ISSUES INVOLVED IN THE PROPOSAL OF THE TREASURY MARCH 3, 1942 TO ELIMINATE THE EXEMPTION OF INTEREST ON OBLIGATIONS OF STATES AND THEIR POLITICAL SUBDIVISIONS

The Congress possesses the power to levy a tax on incomes. Interest paid on State and municipal obligations clearly constitutes income. It would follow, therefore, that such interest is subject to the Federal income tax. Certainly there is no provision of the Constitution which prohibits the imposition of a Federal income tax upon the interest derived from State and municipal obligations. The only possible basis for questioning the constitutional validity of such a tax is therefore the assertion that the holders of such obligations are cloaked with an immunity that may be implied from the Constitution. In 1895 the Supreme Court in Pollock v. Farmers Loan & Trust Co., 157 U.S. 429; 158 U.S. 601, stated that such an immunity existed. But the foundations of this opinion have been so weakened by subsequent decisions that it cannot withstand a direct attack. With it falls the only barrier to the validity of a Federal income tax on the interest received by such bondholders.

A.

The belief that the Pollock decision has no validity today rests upon these bases: First, it may be argued that the adoption of the Sixteenth Amendment to the Constitution affirmatively sanctioned taxation of the income from State obligations, through the express grant of power to the Congress "to lay and collect taxes on incomes, from whatever source derived."

Second, every other claim to private immunity from Federal income taxation, even those formerly recognized by the Court, has now been rejected. The income derived by Government contractors from their contracts was denied immunity in Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) and James v. Dravo Contracting Co., 302 U.S. 134 (1937); the income derived by lessees of Government property from their leased property was denied immunity in Helvering v. Mountain Producers Corporation, 303 U.S. 376 (1936); the income derived by Federal judges from their salary was in effect denied immunity in O'Malley v. Woodrough, 307 U.S. 277 (1939). Most significant of all, State employees, who had enjoyed under Collector v. Day, 11 Wall. 113 (1870), an immunity from Federal income taxation antedating that given to the bondholder by the Pollock case, were held in Graves v. O'Keefe, 306 U.S. 466 (1939, to be subject to Federal income taxation on their salaries. Like the State employee, the bondholder offers services, his capital, to the State at a price and like the employee that price must pay its contribution to the Federal revenues.

Third, the theoretical basis of the Pollock decision, that a tax on the income from State obligations is equivalent to a tax on the bonds themselves and thus is a tax on the power of the State to borrow money, has been flatly rejected by the Supreme Court. In Graves v. O'Keefe, Justice Stone said: "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable." In place of that discarded theory there has been substituted by the Supreme Court the view that a non-discriminatory Federal income tax, directed at all citizens alike, is valid as against any claim to constitutional immunity based upon dealings with State governments. That the economic burden of a State sales tax upon materials sold to a "cost-plus-a-fixed-fee" contractor with the Federal Government "is but a normal incident of the organization within the same territory of two independent taxing sovereignties" was recently announced in Alabama v. King & Boozer, 314 U.S. 1 (1941). From this case it would follow that any burden that may be passed on economically to State governments because of a tax upon the interest derived from bonds issued by such governments is but the normal incident of the existence of two governments within the same territory. Such an indirect and incidental effect does not warrant a restriction of the Federal taxing power.

Fourth, great emphasis is placed by the Supreme Court in its recent opinions on the duty of all individuals to contribute their share to the costs of Government. Equally stressed is the recognition of the dangers inherent in placing restrictions upon the Federal taxing power. The Court has thus clearly recognized that recognition of any immunity on the part of the holders of State obligations would relieve one group of taxpayers from the duty of financial support to the national Government and curtail the sovereign power of that Government to maintain its existence. When the issue is so viewed, the urgency of our present needs for revenue, greater than ever before, compels the conviction that the Supreme Court will refuse to exempt the holders of State bonds from their obligations to the Nation.

B.

Some individuals have asserted that while the Federal Government may possess the power to tax the interest on future issues of State and municipal obligations, such power does not extend to the interest on the outstanding obligations. They support this assertion by claiming that a contract of exemption exists between the Federal Government and the holders of such outstanding obligations.

However, no such contract exists. Although the various revenue acts have excluded from gross income the interest upon such obligations, the exemption provisions in these acts cannot be regarded as contracts between the Federal Government and the States or the bondholders. This exemption, like any other exemption, is simply an expression of legislative policy which may be changed at any time. If such a provision were said to be a contract, on like grounds a salaried taxpayer might claim he had a binding contract right to the earned income credit, a father to the credit for dependent children and so on. In short, to these taxpayers, and to the taxpayer who possesses State and local obligations, the Federal Government has made no promises that existing laws would not be changed.

But, it has been asserted, while no contract exists, at least there is a moral obligation upon the Federal Government not to tax such interest in view of the exemption existing at the time of their issuance. But here again the granting of an exemption does not carry with it the understanding that it will be forever continued. No doubt many investors expected a continued tax-free yield when they purchased the obligations. But it has been pointed out previously that such expectation did not extend to the high rates necessitated by emergency conditions. And every taxpayer takes the chance that the rates of tax and the exemptions thereunder will change. Any other view of the situation would turn the tax laws into static rules and by thus strait-jacketing revenue legislation make it impossible for the Congress to adapt its tax policies to changing conditions.

C.

Finally, it has been contended that the history of the ratification of the Sixteenth Amendment proves that at that time it was the understanding that the words "from whatever source derived" did not give to the Congress the power to levy a tax upon interest from State and local obligations. The communications and speeches of Senators Borah of Idaho and Root of New York have been cited in an effort to show that

Congress did not intend to tax the interest on State and municipal obligations. It should be noted that this issue was not raised until after the Amendment had been submitted to the States for ratification. In fact, there is nothing that was said in the course of the debate in the Congress from which it may be inferred that a single Member 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.

When the Sixteenth Amendment was before the New York State Legislature for ratification, Governor Hughes recommended its rejection on the ground that the Amendment gave to the Federal Government the right to tax the interest on State and municipal securities. Senator Root took the position that the Amendment merely dealt with the problem of apportionment and did not affect the inherent power of the Federal Government to tax incomes. In other words, the Sixteenth Amendment simply permitted Congress to levy an income tax without apportionment among the several States, and that therefore the Amendment did not give to the Congress any power that it did not previously have, so that the rule of the Pollock case was unaffected by its passage. This was also Senator Borah's position. While the New York Legislature rejected the Amendment on Governor Hughes' advice, it was ratified by that State after his departure from office. It is thus apparent that at the time of the ratification of the Sixteenth Amendment by the several States there was reputable authority on both sides of the question with respect to the taxability of interest upon State and local obligations.

There is, however, a stronger answer to this contention. As indicated above, the observations of Senators Borah and Root amount to the assertion that the Pollock case was unaffected by the adoption of the Sixteenth Amendment. But the rule of the Pollock case has since been rejected by the Supreme Court, so that there is no immunity afforded by the Constitution to the interest on these obligations. In this light the references to the Sixteenth Amendment become wholly irrelevant.

Table 1

Tax-exempt State and local securities, by classes of holder, June 30, 1941 1/

Class of holder	Estimated amounts at par value (in billions of dollars)	
Individuals 2/		7.8
Commercial banks		3.7
Insurance companies		2.1
Corporations other than banks and insurance companies		.5
Tax-exempt holders:		
Federal funds	.7	
State and local government funds 3/	4.1	
Mutual savings banks	.5	
Other tax-exempt institutions	.6	
All tax-exempt holders		5.9
All holders		20.0

Source: Treasury Bulletin, February 1942 and Annual Report of the Secretary of the Treasury, 1941.

1/ Including securities of Territories and insular possessions.
2/ Including estates and trusts.
3/ Including trust, investment, and sinking funds, and holdings of Territorial and insular governmental funds.

Table 2

State and local government securities as a percent of gross estate, by size classes of net estate, estate tax returns filed in 1928-1940.

Filing year	Net estate 1/ (in thousands of dollars) 100 under 200	200 under 300	300 under 500	500 under 1,100 2/	1,100 and over
	(State and local government securities as percent of gross estate) 3/				
1928	1.6%	2.3%	2.7%	4.3%	6.2%
1929	1.6	1.8	2.2	4.5	6.0
1930	1.4	2.4	3.0	3.6	7.3
1931	1.9	2.5	4.2	4.8	9.2
1932	2.2	2.6	5.0	8.3	13.3
1933	2.9	5.1	6.6	11.2	21.9
1934	3.4	4.4	5.8	10.0	23.9
1935	3.6	5.7	6.7	11.0	14.4
1936	3.0	5.4	6.3	8.2	12.5
1937	3.1	5.3	5.7	9.2	11.4
1938	2.9	4.4	5.3	8.0	16.1
1939	3.2	4.4	7.1	11.6	22.7
1940	3.1	3.6	6.2	8.8	15.1

Source: Compiled from Statistics of Income.

1/ Before specific exemption.
2/ Includes securities of Territories and insular possessions.
3/ Gross estate includes tax-exempt insurance.

Table 3

Gross annual yields from a taxable security equivalent to specified yields from a wholly tax-exempt security 1/

Net income from other sources 2/	Gross annual yield from a taxable security equivalent to a tax-exempt yield of							
	2½ percent		3 percent		3½ percent		4 percent	
	1941 rates	proposed rates 3/	1941 rates	proposed rates 3/	1941 rates	proposed rates 3/	1941 rates	proposed rates 3/
$ 1,000	2.50	2.50	3.00	3.00	3.50	3.50	4.00	4.00
2,500	2.77	3.21	3.32	3.85	3.87	4.49	4.42	5.13
5,000	2.87	3.47	3.45	4.17	4.02	4.86	4.60	5.56
10,000	3.33	4.03	4.00	4.84	4.67	5.65	5.33	6.45
20,000	4.31	5.56	5.17	6.67	6.03	7.78	6.90	8.89
50,000	6.10	10.42	7.32	12.50	8.54	14.58	9.76	16.67
100,000	7.81	20.83	9.38	25.00	10.94	29.17	12.50	33.33
500,000	10.42	25.00	12.50	30.00	14.58	35.00	16.67	40.00
1,000,000	11.36	25.00	13.64	30.00	15.91	35.00	18.18	40.00

1/ It is assumed that both the taxable and the tax-exempt security are bought at par; and that the income from additional investments, if taxable, would not be large enough to become subject to a higher rate than that applicable to the first dollar of the additional income. The calculations apply to a married person with no dependents, and take into account variations in the personal exemption and earned income credit as well as in tax rates. The earned income credit is assumed to be unaffected by the additional taxable income except in those cases where by statutory definition all net income is deemed earned.

2/ Before personal exemption.

3/ As presented by Secretary Morgenthau to the Ways and Means Committee, March 3, 1942.

Table 4

State and local government securities, by length of time outstanding, 1/ June 30, 1941

Length of time outstanding	Estimated amount (in billions of dollars)
Less than 1 year	2.3
" " 2 years	3.1
" " 3 "	4.2
" " 4 "	4.9
" " 5 "	5.6
" " 6 "	6.5
" " 7 "	7.3
" " 8 "	7.9
" " 9 "	8.4
" " 10 "	9.3

Total amount outstanding 20.0

Source: Compiled from data supplied by the Bureau of the Census, Division of State and Local Government.

1/ Interest-bearing securities only, including those of territories and insular possessions.

Table 5

Gross annual yield from a taxable security equivalent to a 4 percent yield from a wholly tax-exempt security, under tax rates in effect in 1929, 1935, and 1941, and proposed for 1942 1/

Net income from other sources 2/	1929	1935	1941	1942 (proposed rates 3/)
$ 1,500	4.00%	4.00%	4.00%	4.00%
2,500	4.00	4.00	4.42	5.13
5,000	4.02	4.17	4.60	5.56
10,000	4.12	4.37	5.33	6.45
20,000	4.40	4.71	6.90	8.89
50,000	4.82	5.80	9.76	16.67
100,000	5.26	8.70	12.50	33.33
500,000	5.26	10,00	16.67	40.00
1,000,000	5.26	10.53	18.18	40.00

1/ It is assumed that both the taxable and the tax-exempt security are bought at par; and that the income from additional investments, if taxable, would not be large enough to become subject to a higher rate than that applicable to the first dollar of the additional income. The calculations apply to a married person with no dependents, and take into account variations in the personal exemption and earned income credit as well as in tax rates. The earned income credit is assumed to be unaffected by the additional taxable income except in those cases where by statutory definition all net income is deemed earned.

2/ Before personal exemption.

3/ As presented by Secretary Morgenthau to the Ways and Means Committee, March 3, 1942.

Table 6
Securities of States, and of cities with more than 100,000 population, by interest rate, 1939 1/
(Amounts in thousands of dollars)

Interest rate (Percent)	Securities outstanding, at par value					
	States, and cities over 100,000 population		States		Cities over 100,000 population	
	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
1.50	75,980	.8	75,980	2.4	-	-
1.75	43,388	.4	43,388	1.4	-	-
2.00	131,814	1.3	65,153	2.1	66,661	1.0
2.25	233,516	2.4	140,570	4.4	92,946	1.4
2.50	149,174	1.5	50,188	1.6	98,986	1.5
2.75	177,907	1.8	72,600	2.3	105,307	1.6
3.00	713,118	7.3	300,121	9.5	412,997	6.2
3.25	402,411	4.1	136,839	4.3	265,572	4.0
3.50	848,107	8.6	195,681	6.2	652,426	9.8
3.75	230,617	2.4	117,483	3.7	113,134	1.7
4.00	2,267,298	23.1	782,670	24.7	1,484,628	22.3
4.25	1,580,990	16.1	349,750	11.0	1,231,240	18.5
4.50	1,730,479	17.6	435,485	13.7	1,294,994	19.5
4.75	294,902	3.0	124,284	3.9	170,618	2.6
5.00	706,704	7.2	227,626	7.2	479,078	7.2
5.25	15,809	.2	-	-	15,809	.3
5.50	81,963	.8	-	-	81,963	1.2
5.75	14,764	.2	-	-	14,764	.2
6.00	120,871	1.2	52,328	1.6	68,543	1.0
Total	9,819,812	100.0	3,170,146	100.0	6,649,666	100.0
Other rates	1,086,476		166,795		919,681	
Rates not reported	6,999		1,087		5,912	

Source: Bureau of the Census, Division of State and Local Government.
1/ Securities outstanding at close of fiscal years ended in 1939. Debt with original maturity of less than one year is not included.

Table 7

Tax liability assuming interest from State and local government securities (a) tax-exempt and (b) taxable, under present and proposed individual income tax rates, for 25 selected individuals.

(In thousands of dollars)

Case	State and local interest	Taxable net income from other sources 1/	Total income	Present rates: Tax liability: Interest exempt	Present rates: Tax liability: Interest taxable	Present rates: Revenue loss from tax exemption	Proposed rates 2/: Tax liability: Interest exempt	Proposed rates 2/: Tax liability: Interest taxable	Proposed rates 2/: Revenue loss from tax exemption
1	221.9	601.9	823.8	424.2	595.7	171.5	521.4	721.0	199.6
2	236.2	207.9	444.1	126.4	301.2	174.8	164.6	377.2	212.6
3	260.4	148.9	409.3	87.0	276.8	189.8	113.6	348.0	234.4
4	230.9	1,337.5	1,568.4	999.2	1,181.6	182.4	1,182.7	1,390.5	207.8
5	226.9	1,081.0	1,307.9	796.6	975.8	179.2	951.9	1,156.0	204.1
6	215.0	147.8	362.8	83.8	241.8	158.0	110.2	303.7	193.5
7	349.5	144.2	493.7	82.6	339.6	257.0	107.8	422.4	314.6
8	820.7	835.6	1,656.3	605.0	1,251.6	646.6	731.7	1,470.3	738.6
9	162.7	249.8	412.5	158.1	279.2	121.1	204.4	350.9	146.5
10	351.7	275.1	626.8	175.9	442.7	266.8	226.5	543.0	316.5
11	330.7	373.6	704.3	249.9	503.0	253.1	315.8	613.5	297.7
12	773.0	765.1	1,538.1	549.4	1,157.7	608.3	667.6	1,363.2	695.6
13	668.7	305.9	974.6	198.6	712.8	514.2	254.3	856.1	601.8
14	817.4	288.9	1,106.3	186.6	817.2	630.6	239.6	975.3	735.7
15	394.6	376.6	771.2	250.7	553.2	302.5	316.8	672.0	355.2
16	296.5	603.0	899.5	423.2	653.0	229.8	520.2	787.0	266.8
17	404.3	160.1	564.4	94.8	395.3	300.5	123.7	487.6	363.9
18	316.3	915.1	1,231.4	666.8	915.8	249.0	803.1	1,087.8	284.7
19	313.4	278.7	592.1	179.2	416.6	237.4	230.4	512.5	282.1
20	356.5	135.4	491.9	75.1	336.9	261.8	98.9	419.7	320.8
21	1,083.7	4,321.4	5,405.1	3,380.3	4,251.3	871.0	3,868.8	4,844.2	975.4
22	172.6	170.7	343.3	102.2	227.2	125.0	133.2	288.6	155.4
23	226.2	166.9	393.1	99.5	264.5	165.0	129.8	333.4	203.6
24	314.8	331.7	646.5	217.5	457.3	239.8	276.9	560.1	283.2
25	424.8	218.9	643.7	136.2	366.3	230.1	176.6	558.9	382.3
Total	9,969.4	14,441.7	24,411.1	10,348.8	17,914.1	7,565.3	12,470.5	21,442.9	8,972.4

Source: Income items from returns on Form 1040 for 1940.

1/ Exclusive of net long-term capital gains and losses.

2/ As presented by Secretary Morgenthau to the Ways and Means Committee, March 3, 1942.

Table 8

Comparison of the Yields of High-Grade Corporate and Municipal Bonds

Month	Yield on first day of month		Spread
	High-grade corporate bonds 1/	High-grade municipal bonds 2/	
1939-January....	3.01	2.36	.65
February...	2.94	2.33	.61
March......	2.86	2.38	.48
April......	2.93	2.32	.61
May........	2.90	2.37	.53
June.......	2.82	2.26	.56
July.......	2.78	2.26	.52
August.....	2.74	2.27	.47
September..	2.98	2.79	.19
October....	3.28	2.94	.34
November...	3.00	2.55	.45
December...	2.90	2.35	.55
1940-January....	2.83	2.24	.59
February...	2.83	2.28	.55
March......	2.80	2.35	.45
April......	2.73	2.27	.46
May........	2.74	2.21	.53
June.......	2.99	2.66	.33
July.......	2.88	2.34	.54
August.....	2.82	2.17	.65
September..	2.78	2.17	.61
1940-October....	2.69	2.01	.68
November...	2.70	1.94	.76
December...	2.61	1.82	.79
1941-January....	2.57	1.80	.77
February...	2.61	1.97	.64
March......	2.76	2.13	.63
April......	2.72	2.02	.70
May........	2.75	1.92	.83
June.......	2.74	1.77	.97
July.......	2.65	1.69	.96
August.....	2.64	1.70	.94
September..	2.65	1.71	.94
October....	2.62	1.65	.97
November...	2.58	1.57	1.01
December...	2.59	1.60	.99
1942-January....	2.71	1.91	.80
February...	2.80	2.04	.76
March......	2.81	2.19	.62
April......	2.77	2.06	.71

1/ Treasury Department average of high-grade corporate bonds.
2/ Bond Buyer average, 11 first grade cities.

Table 9

Yields of Corporate and Municipal Bonds, Spread, and Federal Individual Income Tax Rates, 1900-42

Year	Annual average yield: High-grade corporate bonds 1/	Annual average yield: Municipal bonds 2/	Spread	Tax rate on bracket immediately above $100,000
1900	4.05	3.12	0.93	0
1901	3.90	3.13	.77	0
1902	3.86	3.20	.66	0
1903	4.07	3.38	.69	0
1904	4.03	3.45	.58	0
1905	3.89	3.40	.49	0
1906	3.99	3.57	.42	0
1907	4.27	3.86	.41	0
1908	4.22	3.93	.29	0
1909	4.06	3.78	.28	0
1910	4.16	3.97	.19	0
1911	4.17	3.98	.19	0
1912	4.21	4.02	.19	0
1913	4.42	4.22	.20	5
1914	4.46	4.12	.34	5
1915	4.64	4.16	.48	5
1916	4.49	3.94	.55	7
1917	4.79	4.20	.59	31
1918	5.20	4.50	.70	64
1919	5.49 3/	4.46	1.03 3/	60
1920	6.12	4.98	1.14	60
1921	5.97	5.09	.88	60
1922	5.10	4.23	0.87	56
1923	5.12	4.25	.87	42
1924	5.00	4.20	.80	43
1925	4.88	4.09	.79	25
1926	4.73	4.08	.65	25
1927	4.57	3.98	.59	25
1928	4.55	4.05	.50	25
1929	4.73	4.27	.46	24
1930	4.55	4.07	.48	25
1931	4.58	4.01	.57	25
1932	5.01	4.65	.36	56
1933	4.49	4.71	-.22	56
1934	4.00	4.03	-.03	56
1935	3.60	3.41	.19	56
1936	3.24	3.07	.17	62
1937	3.26	3.10	.16	62
1938	3.19	2.91	.28	62
1939	3.01	2.76	.25	62
1940	2.84	2.50	.34	66
1941	2.77	2.10	.67	69
1942 4/	2.84	2.49	.35	

1/ From 1900 through 1918, Standard Statistics Co. average for 15 high-grade railroad bonds; other years Moody's Investors Service average for high-grade corporate (Aaa) bonds.

2/ Standard Statistics Co. average.

3/ Standard Statistics Co. average of yields of high-grade railroad bonds was 5.29 percent for 1919, and the spread based upon this average was 0.83 percent.

4/ April 1, 1942.

Table 10

Treatment of interest from Federal, State and local Government obligations under State individual income taxes, as of January 1, 1942

State	Interest from obligations of the: Home State	Other States	Political subdivisions of the: Home State	Political subdivisions of the: Other States	Federal Government and its agencies
Alabama	Exempt	Taxed	Exempt	Taxed	Exempt 1/
Arizona	Exempt 2/	Taxed	Exempt 2/	Taxed	Exempt 3/
Arkansas	Exempt	Taxed	Exempt	Taxed	Exempt
California	Exempt 4/	Taxed	Exempt 4/	Taxed	Exempt 5/
Colorado	Taxed	Taxed	Taxed	Taxed	Exempt 6/
Delaware	Exempt	Taxed	Exempt	Taxed	Exempt
Georgia	Exempt	Taxed	Exempt	Taxed	Exempt 6/
Idaho	Taxed	Taxed	Taxed	Taxed	Exempt 3/
Iowa	Taxed	Taxed	Taxed	Taxed	Exempt 6/
Kansas	Taxed	Taxed	Taxed	Taxed	Exempt 6/
Kentucky	Exempt	Taxed	Exempt	Taxed	Exempt
Louisiana	Exempt	Taxed	Exempt	Taxed	Exempt 6/
Maryland	Exempt	Taxed	Exempt	Taxed	Exempt 5/
Massachusetts	Exempt 7/	Taxed	Exempt 7/	Taxed	Exempt
Minnesota	Exempt	Taxed	Exempt	Taxed	Exempt 1/
Mississippi	Exempt	Taxed	Exempt	Taxed	Exempt
Missouri	Exempt	Taxed	Exempt	Taxed	Exempt
Montana	Taxed	Taxed	Taxed	Taxed	Exempt 8/
New Hampshire	Exempt	Taxed	Taxed 9/	Taxed	Exempt 3/
New Mexico	Exempt	Taxed	Exempt	Taxed	Exempt
New York	Exempt	Taxed	Exempt	Taxed	Exempt
North Carolina	Exempt	Taxed	Exempt	Taxed	Exempt 10/
North Dakota	Exempt	Taxed	Exempt	Taxed	Exempt
Oklahoma	Taxed 8/	Taxed 8/	Taxed 8/	Taxed 8/	Exempt 6/
Oregon	Taxed	Taxed	Taxed	Taxed	Exempt 5/
South Carolina	Exempt	Taxed	Exempt	Taxed	Exempt
South Dakota	Taxed 11/	Taxed	Taxed	Taxed	Exempt 5/
Utah	Exempt	Taxed	Taxed	Taxed	Exempt 5/
Vermont	Exempt 12/	Taxed	Exempt 12/	Taxed	Exempt
Virginia	Exempt	Taxed	Taxed	Taxed	Exempt
West Virginia	Exempt	Taxed	Exempt	Taxed	Exempt
Wisconsin	Taxed	Taxed	Taxed	Taxed	Exempt 3/

See next page for footnotes.

Table 10 (Continued)

1/ Recent legislation (1939 to 1942) provides that interest from obligations of the United States shall be included in gross income insofar as the State is constitutionally or legally authorized to tax such income.

2/ Exemption is restricted to interest from bonds.

3/ Exempt by regulation.

4/ Restricted to bonds issued after 1902.

5/ Excludes from gross income all income which the State is prohibited from taxing under the Constitution or laws of the United States.

6/ Recent legislation (1939 to 1942) repealed the section which excluded from gross income the interest upon obligations of the United States.

7/ Restricted to post-1906 State and post-1908 local issues marked tax-exempt.

8/ No specific exemption in statute or regulation.

9/ Applicable to post-1923 issues.

10/ Exemption is conditional upon interest upon obligations of the State of North Carolina or of its political subdivisions being exempt from United States income taxes.

11/ Interest on Soldiers' Compensation bonds and on Rural Credit bonds issued prior to July 1, 1927 is exempt.

12/ Exempt when the rate of interest does not exceed 5 percent per annum.

Table 11

Estimated maturities of State and local government securities outstanding June 30, 1941 1/

(Amounts in millions of dollars)

Date of maturity, fiscal years ended June 30	Yearly maturities 2/		Cumulative maturities	
	Amount	Percent of total	Amount	Percent of total
1942	2,021 3/	10.2	2,021	10.2
1943	905	4.6	2,926	14.8
1944	904	4.6	3,830	19.4
1945	849	4.3	4,679	23.7
1946	725	3.6	5,404	27.3
1947	737	3.7	6,141	31.0
1948	651	3.3	6,792	34.3
1949	673	3.4	7,465	37.7
1950	682	3.4	8,147	41.1
1951-1955	3,396	17.1	11,543	58.2
1956-1960	2,779	14.0	14,322	72.2
1961-1965	2,267	11.4	16,589	83.6
1966-1970	1,138	5.7	17,727	89.3
1971-1975	686	3.5	18,413	92.8
1976-1980	1,235	6.2	19,648	99.0
1981-1985	182	.9	19,830	99.9
1986-1990	29	.1	19,859	100.0
1991-1995	1	4/	19,860	100.0
Total	19,860	100.0		

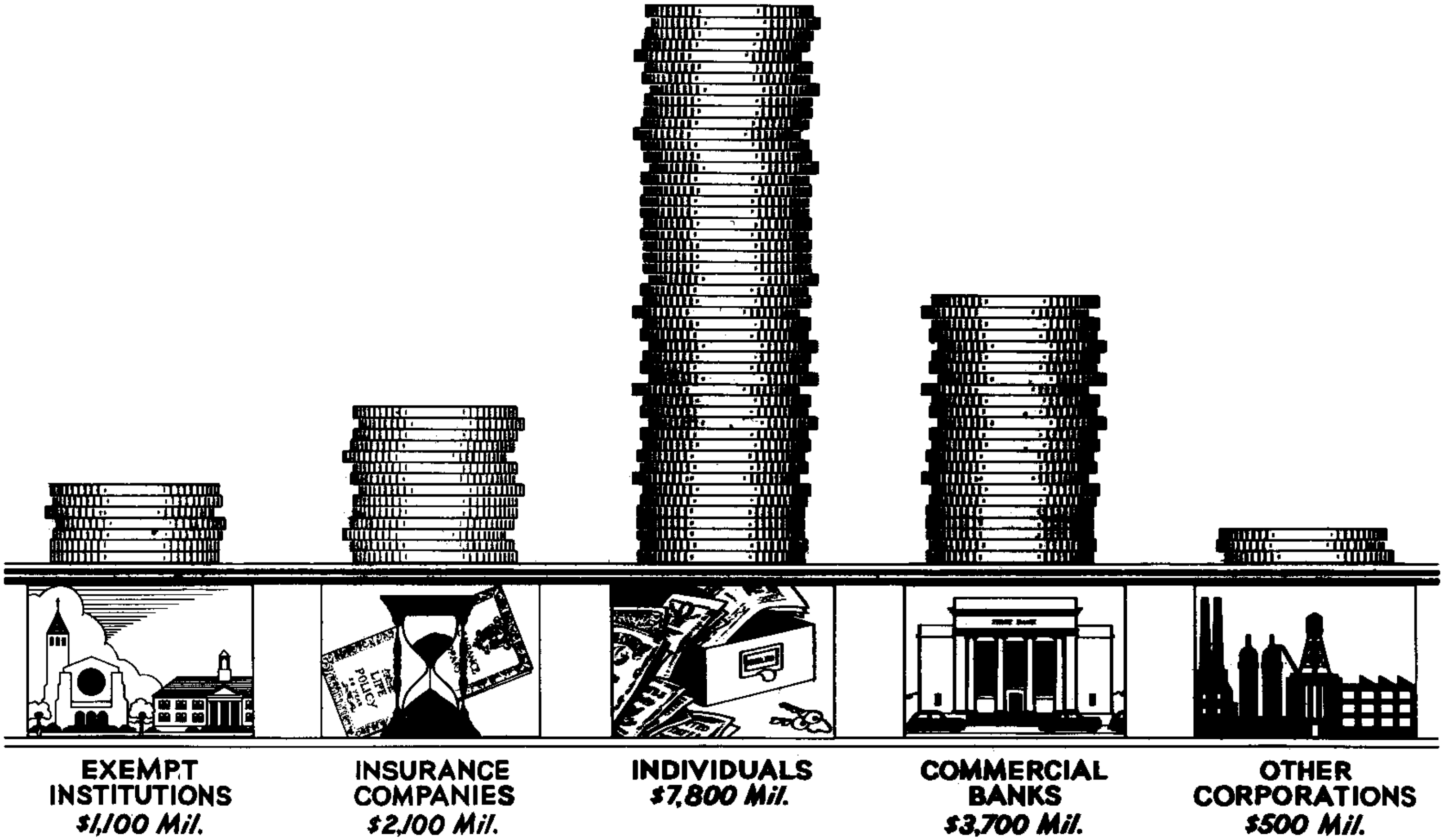
Source: Bureau of the Census, Division of State and Local Government.

1/ Excluding securities of Territories and insular possessions.
2/ By maturity dates, without reference to optional earlier call dates.
3/ Includes $1,144 millions short-term interest-bearing securities.
4/ Less than .05 percent.

Chart 1

OWNERSHIP OF STATE AND LOCAL GOVERNMENT SECURITIES

Outstanding June 30, 1941*



*Excludes $4,800 Millions held by Governments

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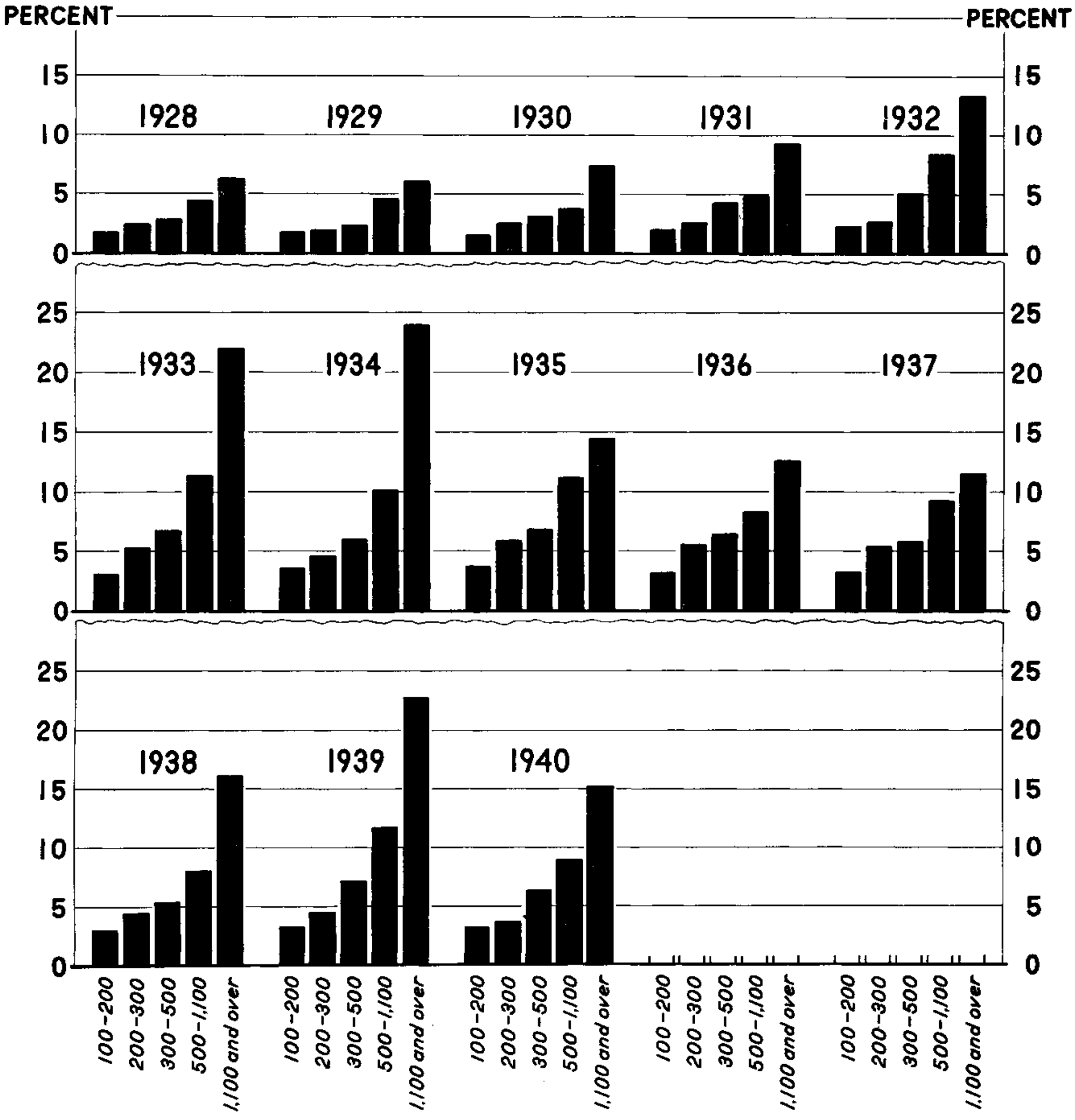
B-293

Chart 2

PERCENTAGE OF ESTATES IN STATE AND LOCAL SECURITIES

Estate Tax Returns Filed, 1928-1940



NET ESTATE, BEFORE EXEMPTION, IN THOUSANDS OF DOLLARS

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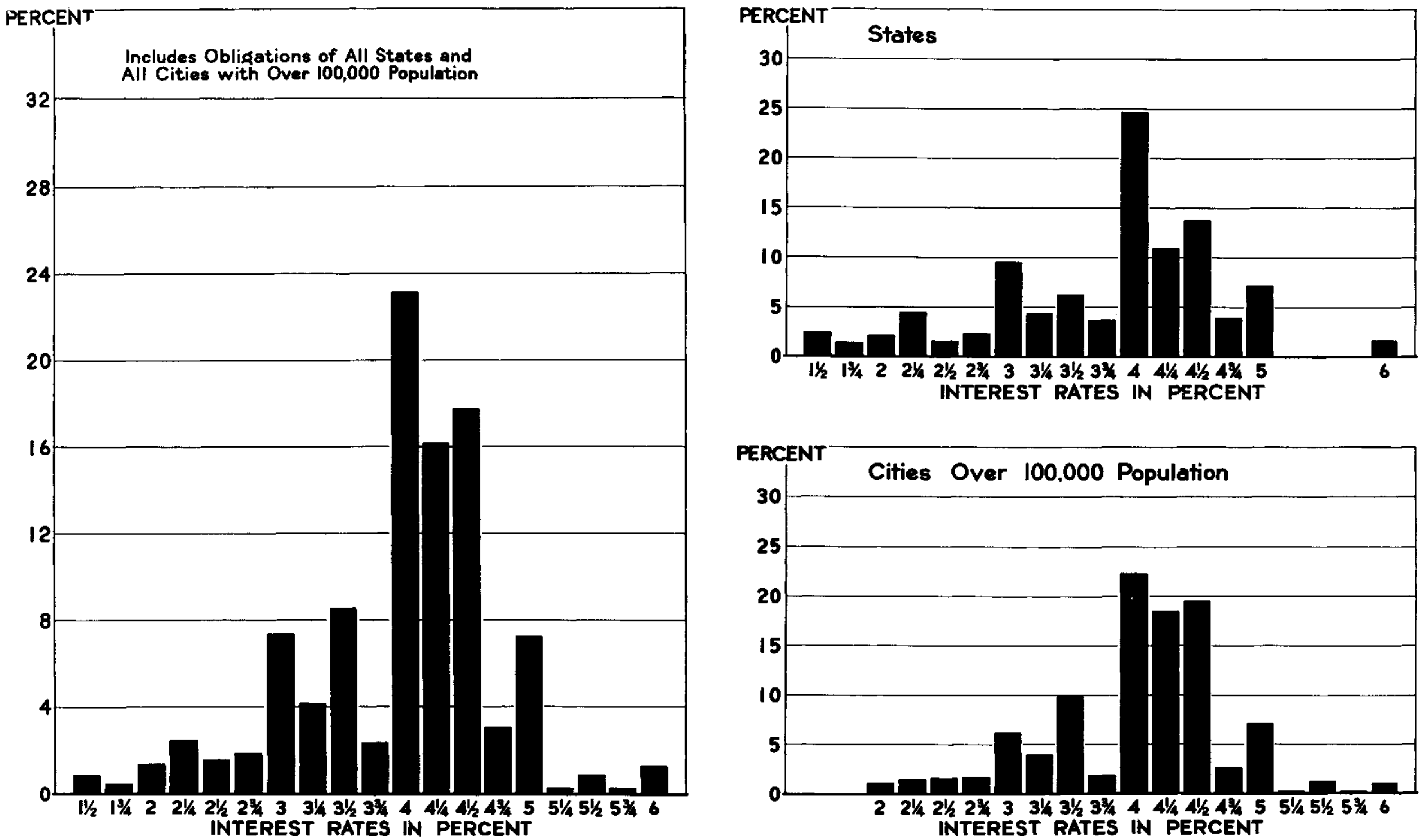
Chart 3

PERCENTAGE DISTRIBUTION OF STATE AND CITY DEBT, BY INTEREST RATES, 1939



Source: Bureau of the Census.

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Chart 4

COMPARISON OF THE YIELDS OF HIGH-GRADE CORPORATE AND MUNICIPAL BONDS

First Day of the Month Figures, 1939 to Date

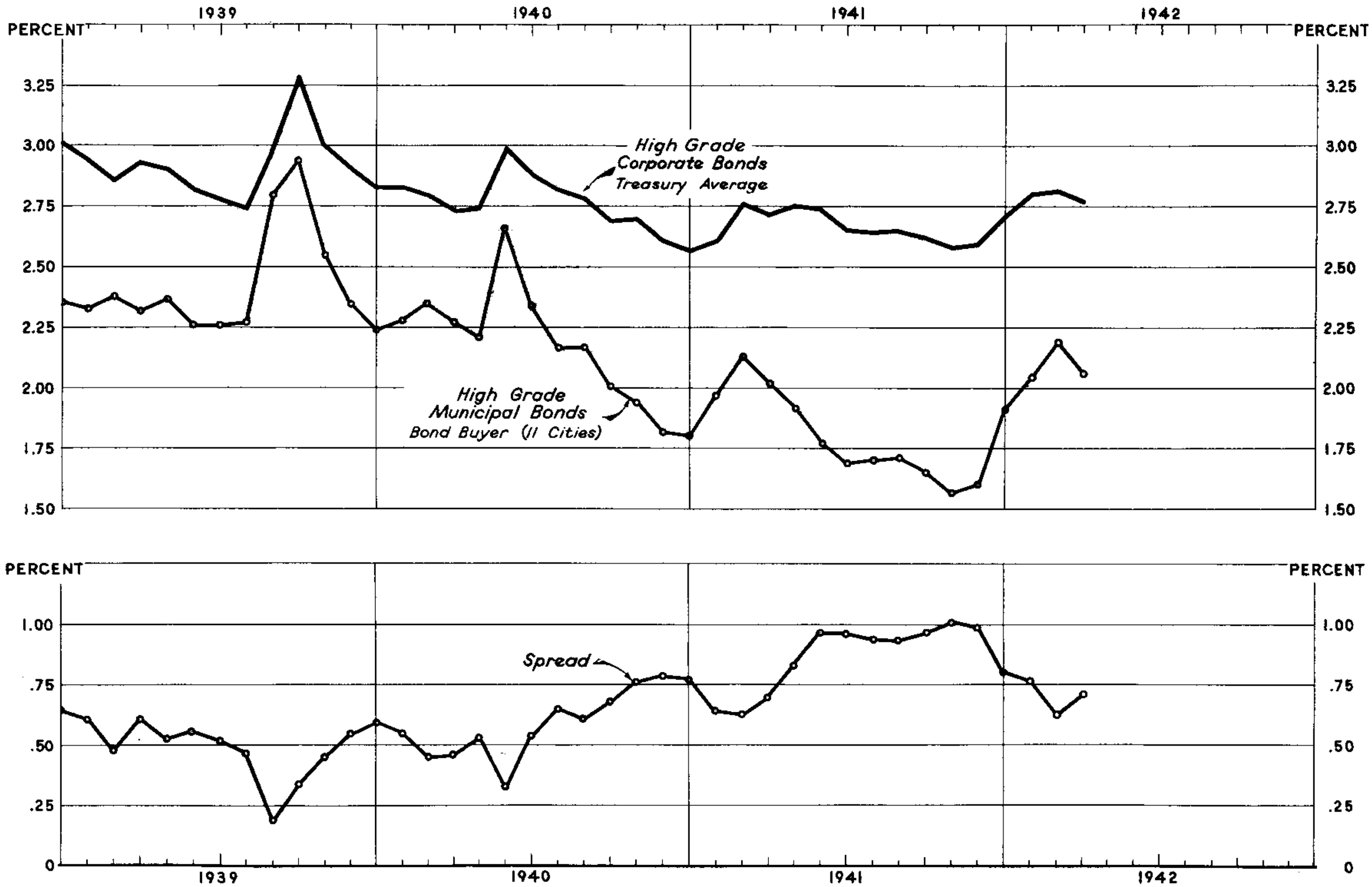
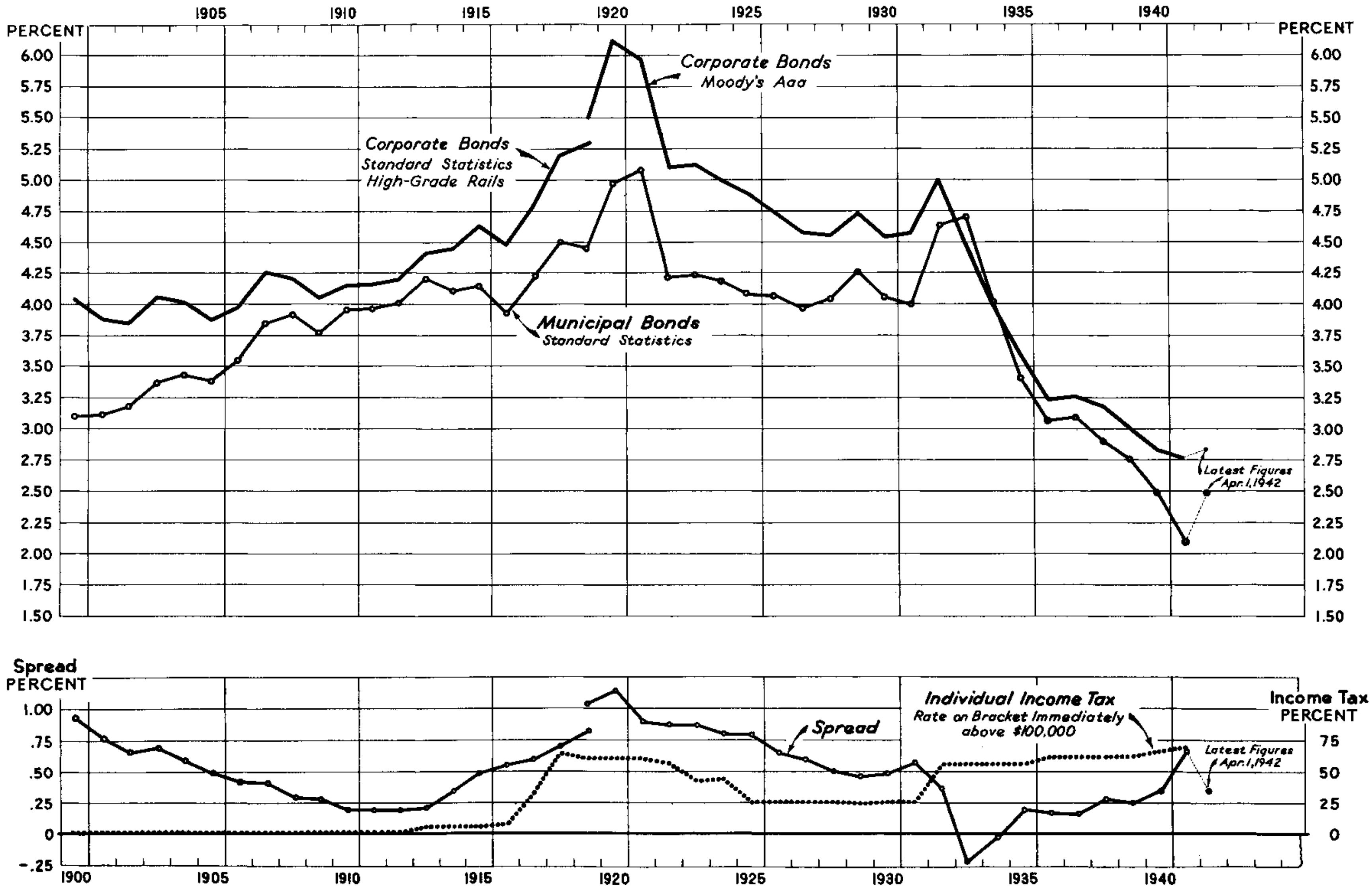


Chart 5

COMPARISON OF THE SPREAD IN YIELD BETWEEN CORPORATE AND MUNICIPAL BONDS WITH THE FEDERAL INDIVIDUAL INCOME TAX, 1900–'42

(Yields Are Annual Averages)



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B-234-1