A review by the **Federal Reserve Bank of Chicago**

Business Conditions

September 1971

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THE Trend OF BUSINESS

The freeze and after

Evaluations of the actions taken, and proposals made, by the President on August 15—soon christened the New Economic Policy (NEP)[1] by the press—have dominated discussions of economic developments ever since. The President's program called for a 90-day wage-price freeze, suspension of the convertibility of the dollar into gold, and imposition of a 10 percent surcharge on imported goods already subject to tariffs and not under formal quotas. The President also asked Congress to reenact the investment tax credit, repeal the excise tax on autos, and increase individual income tax exemptions. In addition, he outlined a plan to reduce government expenditures, and indicated additional tax incentives would be forthcoming.

Although sharp criticisms were voiced, the New Economic Policy was generally welcomed. Most people have been deeply disturbed by the nation's economic problems—lack of growth in output and employment, continued price inflation, and a deficit in the nation's balance of foreign trade.

A reasoned assessment of the full impact of the Administration's program will not be possible until 1972 is well advanced. Much depends on the speed, and manner, of congressional action on proposed legislation. Even in retrospect, universal agreement on the effectiveness of the program is unlikely, given individual biases and alternative methods of analysis. Nevertheless, some tentative conclusions can be drawn concerning the first phase of the program:

- First, there has been general cooperation with the wage-price freeze by management, labor, and the public.
- Second, consumer purchases of autos increased sharply in late August and in September, perhaps stimulated by the belief that prices would rise when the freeze ended, and the 10 percent import surcharge became effective.
- Third, although no upsurge in manufacturers' orders was evident in the weeks following the freeze, most analysts agreed that the NEP would be effective in achieving its principal objectives.

The faltering revival

At the time of the President's message, it appeared to most observers that the gross national product (total purchases of goods and services) would reach $1050 billion for the year 1971. If achieved, the gain from

[1]Somewhat ironically, the term NEP was used in 1921 to describe the temporary restoration of the capitalistic elements in the Russian Soviet economy.

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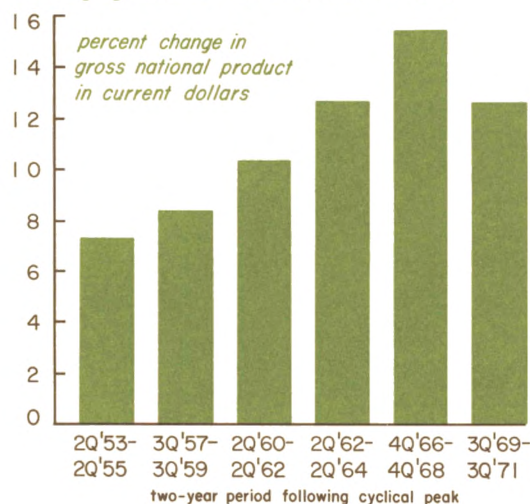
1970 would have been about 8 percent, the largest since 1966. But most of the rise in spending would have reflected inflation, with the price level up about 5 percent. Real growth was projected for 1971 at about 3 percent.

A 3 percent rise in real output is less than the 4.3 percent average annual rise in the decade ending in 1969. Moreover, this modest improvement followed a slight decline in 1970—the first since 1958—which, in turn, had followed an increase of less than 3 percent in 1969.

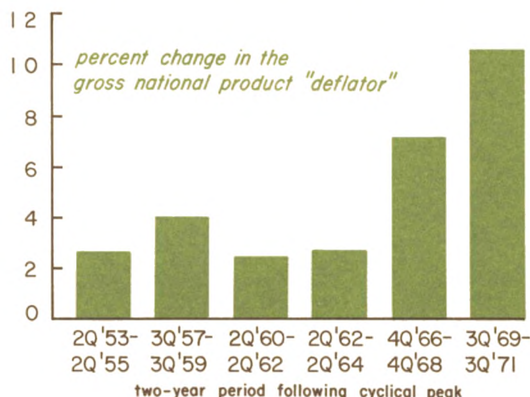
Unemployment was estimated at 6.1 percent of the nation's civilian labor force in August. (Except for Michigan, unemployment rates in Midwest states were below the national average.) About one-fourth of the nation's manufacturing facilities were idle. Wage and salary employment was about unchanged in August after declining in the two previous months. Industrial production declined in both July and August. These unfavorable readings of economic measures partly reflected the sharp cutbacks in steel output following agreement on a new labor contract on August 1. Nevertheless, the goods-producing sectors of the economy generally lacked vigor, with marked exceptions in residential construction—and related areas such as building materials, mobile homes, and major household appliances—and in activities related to environmental improvement.

Among the sectors most seriously depressed in the third quarter were output for defense, down 25 percent from the 1968 peak, and business equipment, off about 15 percent from the 1969 peak. Defense output has been less important in the Seventh Federal Reserve District than in the nation generally, although a few centers have been hard hit by procurement cutbacks. Reduced demand for business equipment, however, has been a significant depressing factor through-

The dollar volume of purchases of goods and services has increased sharply since 1969, but . . .



Price inflation in the past two years has been much faster than in comparable earlier periods



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out this region, which produces about one-third of the nation's requirements.

While output and employment declined in the summer months, price increases continued. Although there was evidence of a moderate slowing in inflation prior to August 15, both the wholesale and consumer price indexes rose appreciably in the month.

Two years from the peak

Probably the best index of the performance of the economy is "real GNP," the gross national product adjusted for price changes. This measure includes output of all sectors of the economy—private and public.

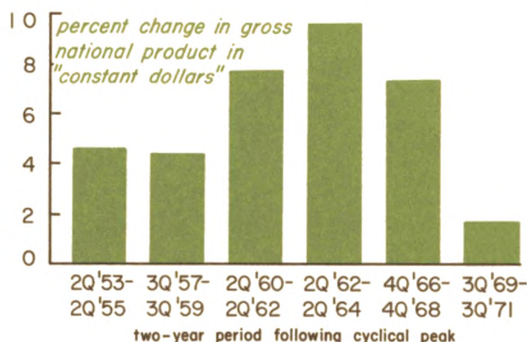
Real GNP reached a cyclical peak in the third quarter of 1969 after a record rise starting in early 1961. The long uptrend was almost continuous quarter by quarter, with two periods of sluggish growth in 1962 and 1966-67, now termed "mini-recessions."

As the economy began to slip in late 1969, monetary and fiscal policies were reversed to provide stimulus in place of restraint. Throughout 1970, and thus far in 1971, money and credit have grown at a rapid pace, with some moderation recently, and the federal budget has shifted toward an increasingly heavy deficit position, chiefly because of weakness on the revenue side.

As in past recessions, total spending has responded to fiscal and monetary stimulus, but the performance of employment and output have been disappointing in comparison to business revivals earlier in the postwar period. It was the failure of physical measures to respond, along with continued price and wage increases, that brought pressures for the Administration to resort to some kind of an "incomes policy," including imposition of direct controls.

Some observers have insisted that the recovery was "on track" prior to the NEP

After adjustment for higher prices, growth in purchases has been less than half as great as in past periods



program, and was proceeding "normally." Alternative methods of making comparisons, of course, bring varying results. It is possible, for example, to chart an improvement in the economy from the "troughs," or low points, of the declines in activity. But this approach does not consider either the length of time that output remained below potential, or special factors making for depressed activity in given periods. The low quarter for most physical measures of activity in the 1969-70 recession was the fourth quarter of 1970, but that period was depressed by a strike that idled more than half of the auto industry.

The accompanying charts show the percentage changes in the levels of basic economic measures two years after cyclical peaks in real GNP. The two-year period permits the use of estimates for the third quarter of 1971. The first postwar recession that began in the fourth quarter of 1948 is omitted from the charts because economic measures were skyrocketing in late 1950 as a result of the Korean War. The cyclical peaks used in the

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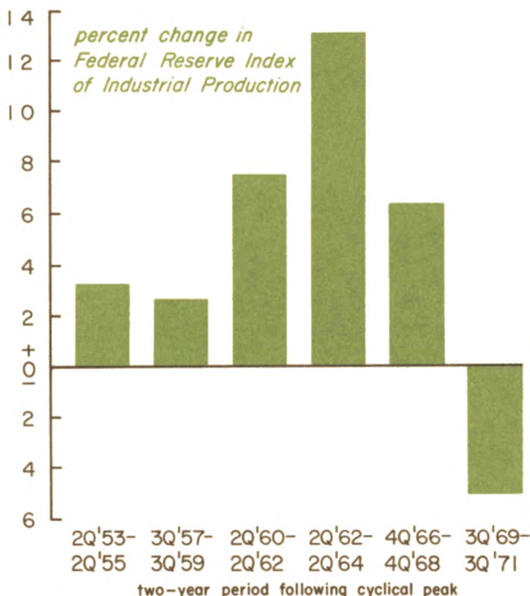
charts for comparison with the recent experience are the second quarter of 1953, the third quarter of 1957, and the second quarter of 1960. Although not technically the starting points of recessions, the second quarter of 1962 and the fourth quarter of 1966 are included also as starting points because these quarters were followed by periods in which the uptrend was temporarily halted.

A look at the record

In the third quarter of 1971, estimated current dollar GNP was up 13 percent from its level of two years earlier, a much larger gain than in any of the comparisons for the 1950s. But the general price level, represented by the "gross national product deflator," rose 11 percent in the past two years —more than in any of the other periods of comparison. As a result, real GNP rose only about 2 percent in the past two years, less than half as much as in any of the other periods.

Third-quarter industrial production output of mines, factories, and utilities—was below the 1969 peak



Turning to the Federal Reserve index of industrial production (a measure of the physical output of factories, mines, and electric and gas utilities), the recent performance of the economy is even more unfavorable. Industrial production, which rose at least 3 percent in each of the earlier two-year periods, was 5 percent *less* in the third quarter of 1971 than in the third quarter of 1969.

Wage and salary employment in nonagricultural establishments was almost exactly the same in the recent period as two years earlier. This performance appears unfavorable in the comparisons except for 1953-55, which resembles the recent period in coinciding with a retrenchment of the armed forces.

The unemployment rate, averaging about 6 percent in the third quarter of 1971, is higher than in any of the comparative periods of recovery. Unemployment had reached higher levels at the worst points in earlier postwar recessions than in the recent period, but a pronounced improvement had been evident within two years of the cyclical peak.

The money supply (demand deposits and currency in the hands of the public) is a popular measure of the thrust of monetary policy. From the third quarter of 1969 to the third quarter of 1971, the money supply increased more than 12 percent—far more than in any of the comparison periods except for 1966-68.

The relation of the money supply to measures of activity is best examined in terms of changes in turnover or "velocity." One useful measure of money turnover is "income velocity" calculated, in this case, by dividing

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current dollar GNP (less federal expenditures) by the average money supply (which excludes federal deposits) for each period. The velocity ratio has risen only slightly since 1966, and much less than in the earlier periods. The provision of more money has been accompanied by a relatively smaller increase in spending than in earlier periods.

Toward Phase II

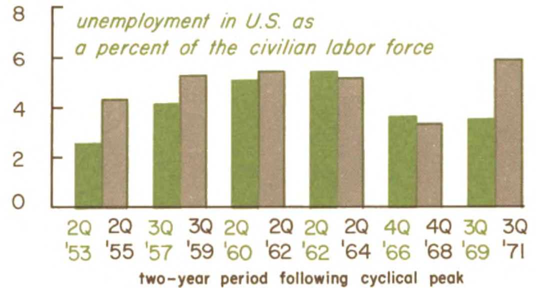
On September 9, the President told a joint session of Congress that the wage-price freeze would not be extended beyond the 90-day period ending November 13, but that a new, more flexible, program of controls was being formulated. Later in the month he stated that "strong, effective" restraints on prices and wages in major industries would be maintained. Further details were not forthcoming, but the public was assured that the new, longer-term program, commonly termed "Phase II," would be announced a month ahead of the expiration of the freeze to allow affected parties to prepare to cooperate.

Administration spokesmen are well aware of the problems of controlling the multitude of private decisions on prices and wages that take place each day in a free enterprise economy. They know that incomes policies pursued in recent years in other industrialized nations have not shown outstanding success over long periods of time. Short of a completely controlled economy with allocations, or rationing, of materials and manpower, flexibility of prices and wages is necessary to channel resources efficiently to sectors of greatest need. The decision to turn to controls was influenced by evidence that prices and wages in important sectors were not responding normally to market forces of supply and demand.

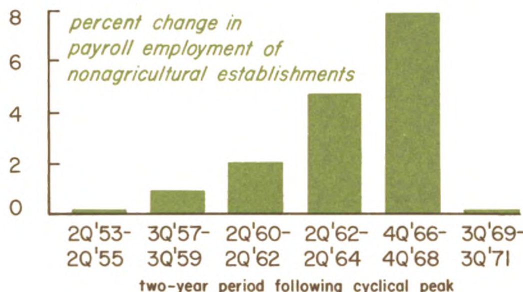
The wage-price guideposts announced in 1962 by the Kennedy Administration were based on the proposition that compensation, profits, and other costs could rise as fast as output per manhour without pushing up prices. The guideline originally was a 3.2 percent annual increase based on average productivity gains of the past.

Evaluations of the 1962 guidelines range all the way from the conclusion that they were highly effective to the other extreme that they

Unemployment in the third quarter averaged about 6 percent; a higher rate than in comparable periods



Wage and salary employment is about the same as two years ago, most periods showed gains



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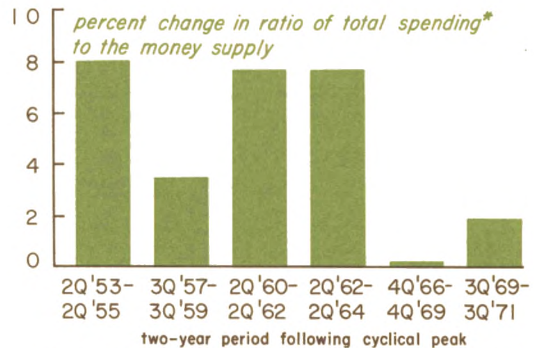
accomplished nothing. Perhaps the answer is somewhere in between, that the guidelines supplemented generally competitive market conditions in the first half of the 1960s in promoting relative price stability. In any case, price inflation accelerated in 1966 and the following years, and the guidelines fell into oblivion. The Vietnam War absorbed a growing share of the nation's output, and taxes were raised belatedly. Shortages of resources, especially manpower, caused the rise in prices and wages to accelerate.

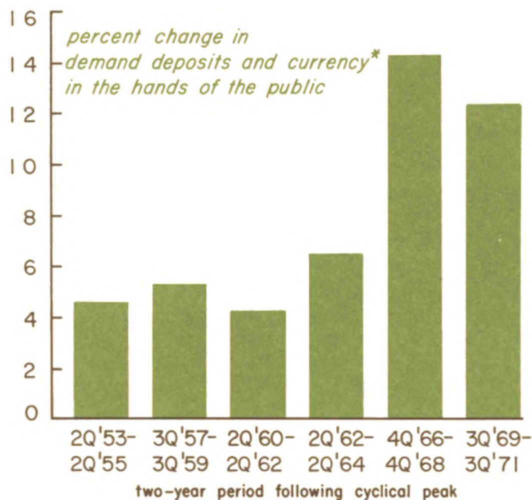
Current economic conditions resemble those of the early 1960s more closely than those of the late 1960s in that overall demand is not outrunning supply. But the forces underlying the price-wage spiral remain strong. The freeze, and the apparatus of Phase II, may provide the means for bringing negotiated wage settlements, and cost-push price increases, back into touch with market forces.

But the money turnover, or velocity, increased slightly in recent years, much less than in the 1950s



*Gross national product in current dollars, less federal expenditures.

The money supply in the third quarter averaged 12 percent higher than two years earlier



*Daily averages for each quarter.

Although many forecasters are optimistic about the chances of slowing price inflation, few would be so bold as to suggest a rate of price advance of less than 3 percent for 1972. First, too many sectors are still in the process of "catching up" to what interested parties believe is an equitable position. Second, while the President has broad authority to "issue orders and regulations . . . to stabilize prices, rents, wages and salaries" under the Economic Stabilization Act of 1970, an immense administrative apparatus, apparently not now contemplated, would be required to force compliance. Third, major elements in the NEP, such as tax reductions and restrictions on imports, are inherently inflationary. Tax cuts increase spending power. Steps to improve the balance of trade tend to raise prices of imported goods.

Prospects for prosperity

In the first half of 1971, residential con-

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struction was the only vigorous major sector of the economy, encouraged by ready access to credit and special government programs. In the third quarter, residential construction activity accelerated further, and projections for the year were raised. Most analysts now see housing starts totaling 2 million units for 1971, and shipments of mobile homes at 500,000—each figure a record by a wide margin. The Midwest housing market is relatively stronger than that of the United States as a whole.

In recent months, retail sales have accelerated, especially sales of durable goods. Despite earlier expressions of pessimism in surveys of consumer sentiment, increases in spending apparently are now matching, or exceeding, gains in income. In the process, consumers are using credit more freely.

Early in 1971 it was commonly proclaimed that the consumer "holds the key" to the outlook. It now appears that "the key has been turned." Increases in federal government spending will continue to be dampened by economy programs, and increases in state and local spending have been slowed by financial stringencies. With consumers doing their part, and with government spending under restraint, the spotlight now shifts to business investment.

Although the situation varies from industry to industry, business inventories, overall, are not high relative to current sales and shipments. A continued rise in consumer spending can be expected to induce a rise in business inventories to maintain adequate stocks.

Except for public utilities, expenditures on new plant and equipment have been one of the weakest sectors of the economy. Reenactment of the investment tax credit, equivalent to a price cut, will tend to encourage the implementation of marginal projects. A strong revival in plant and equipment spending, however, must await some narrowing of the margin of unused capacity in manufacturing. Such a development may become apparent in 1972 if the expansive standard forecast for the general economy is realized.

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Congress and the Fed view bank taxation

The federal statute governing state and local taxation of national banks, which was materially revised in 1969, should be amended further, in the judgment of the Federal Reserve Board.[1] Some of the statutory changes made in 1969 took effect when the law was signed by the President (December 24, 1969), and others are scheduled to become effective on January 1, 1972, unless further action is taken before that time.

From the inception of the national banking system down to the present, state and local governments have had the power to tax nationally-chartered banks, but this power has been narrowly circumscribed by federal statutes. From 1864 until 1923, only one method of taxing banks as such was authorized for use by the states.[2] The bank tax that any state was permitted to use was the so-called "share tax"—a levy by value on the capital stock of national banks located within the state.

The action of Congress in restricting the taxability of national banks was consistent with the view that these institutions were federal instrumentalities in the sense that they were charged with performing certain duties as agencies of the federal Treasury and playing a vital role in providing a sizable share of the nation's stock of money. Insulating the national banks against the full force of the states' taxing powers was a phase of the effort by Congress to protect the integrity of the federal government and its instrumentalities.

With establishment of the Federal Reserve System in 1914 and designation of the Reserve banks as fiscal agents of the U. S. Treasury, the distinction between national and state-chartered banks in terms of a fiscal-agency role largely disappeared. This change in the status of the national banks was one of the reasons for questioning the need for, and appropriateness of, special provisions for the tax status of these banks. Later on, in 1923, the federal statute was liberalized. The door was opened for the taxation of national bank dividends as part of the incomes of national bank shareholders, and for the direct levy of state income taxes upon the net incomes of national banks. It was specified, however, that the selection of either of these methods of taxation, or the retention of the longstand-

[1]The Board report accompanied by a supporting staff study, was submitted to the Senate Committee on Banking, Housing and Urban Affairs on May 4, 1971. It has been published by the U. S. Government Printing Office as **State and Local Taxation of Banks** (92nd Congress, 1st Session, Committee Print).

Section 4(a) of P. L. 91-156, which effected the 1969 amendments to the federal law (Section 5219 of the Revised Statutes, or 12 U. S. C. 548), requested the Federal Reserve to conduct a study of the probable impact on the nation's banking systems and other economic effects of the changes made by the substantive provisions of P. L. 91-156 and to make recommendations for additional legislation.

[2]Real estate owned by national banks has always been subject to the same tax treatment as real estate owned by others. Personal property in the hands of national banks, however, has not been subject to state and local taxation.

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ing share tax, would rule out use of either of the other two tax forms.

In 1926, the statute was amended again by adding another option to the measures available to the states after 1923. This was a franchise or excise tax bearing upon banks as corporate entities, with the tax liability measured by total net income. In effect, this type of tax enabled the states to subject to an equivalent of the conventional corporate income tax the earnings on national bank holdings of U. S. obligations, the yields on which are not directly taxable as income.

In each version of the statute (Section 5219) in effect over the period from 1864 until 1969, limits were established to prevent the application to national banks of tax rates higher than those applicable to comparable subjects of taxation. Moreover, whichever one of the optional forms of tax a state selected, the jurisdiction to tax was restricted to those national banks having their principal offices within the state. An exception to this was a 1926 provision authorizing the states to tax dividends paid to residents by banks headquartered in other states. The statutory change made in 1969 was largely motivated by two decisions of the U. S. Supreme Court upholding the restrictions in Section 5219 and turning back state legislative efforts to subject national banks to state sales and documentary stamp taxes.

Over the years since the great Depression, state and local tax structures have been under considerable strain, and legislatures have been aggressively exploring means of increasing revenues. Quite understandably, attention came to focus on potential revenue that might be realized from sources that had long been largely or partially beyond the reach of state and local taxation. The national banks, of course, were a case in point. Moreover, the existence of special federal protection of the national banks historically had been a strong influence on the state tax treatment of state-chartered banks and other financial institutions. Thus, liberalization of the federal statute by either legislative action or judicial interpretation could contribute far more to the states' revenues than the taxes levied on national banks alone.

The 1969 amendment effectively removes existing restrictions upon the powers of the states to tax national banks, beginning in 1972. The language of the so-called "permanent amendment" of Section 5219 provides that "a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located." During the present transition period, which began on December 24, 1969 and is now scheduled to end on December 31, 1971, a special set of interim provisions relating to the states' taxing powers is in effect. These, of course, will lapse in 1972, when the permanent amendment takes effect, assuming no further congressional action is taken.

The Federal Reserve's proposals

The new amendments to Section 5219 that the Federal Reserve Board believes to be desirable would extend indefinitely certain of the restrictions on the states' ability to tax national banks. For one, the Board proposes that Congress continue the present denial of authority for state and local governments to tax the intangible personal property of national banks, and extend that denial to intangibles owned by state-chartered banks and other depositary institutions (mutual savings banks, savings and loan associations, and credit unions). Second, the Board endorses the congressional effort to liberalize the states' powers to tax national banks but recommends that the law limit the circum-

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Bank Taxation in the Seventh District

Tax laws of the states in the Seventh District exemplify the diversity in state taxation of banks. Recent administrative or statutory changes in taxes levied on district banks are representative of types of changes in bank tax liability that followed the December 24, 1969 amendment of Section 5219. Banks in Iowa, Michigan, and Wisconsin are taxed according to or measured by their net income, with some variation in the definitions of net income and at different rates. Illinois taxes bank shares as personal property, and state banks are subject to the corporate income tax. Indiana levies a tax on gross bank income and taxes owners of capital stock and deposits in banks by assessing the tax at the location of the business.

In 1970, **Iowa** repealed a share tax, imposed a graduated franchise tax on taxable net income, and began taxing tangible personal property of banks. National banks became liable for the sales and use tax, and a sales tax was levied on bank service charges.

In **Michigan,** the financial institutions tax is in lieu of all taxes except realty taxes and sales and use and similar excise taxes; the rate is higher than the corporate franchise tax rate. Bank shares and intangibles of financial institutions are exempt from the intangible personal property tax; owners of deposits are exempt if the bank elects to pay the tax. National banks became liable for the use tax on December 24, 1969.

In **Wisconsin,** banks are taxed under the corporate franchise tax in lieu of all taxes on capital, surplus, property, and assets except real estate and tangible personal property that is not used in banking offices. On January 1, 1970, use taxes applied to national banks.

Illinois taxes bank shares as personal property. Although personal property of individuals was to be exempt from taxation effective January 1, 1971, the Illinois Supreme Court has ruled that the exemption is in violation of the U. S. Constitution. State banks are subject to the corporate tax, but national banks are exempt until the permanent amendment of Section 5219 takes effect. Early in 1970, banks were subject to the realty transfer tax, and sales by national banks were subject to the use and sales tax.

On July 1, 1971, national banks doing business in **Indiana** were made taxable under the Indiana Gross Income Tax Act that previously had applied to state-chartered banks. A tax on shares of capital stock and deposits is assessed to the owners at the location of the business; a state bank that assumes the tax may credit the amount of gross income tax paid against its deposit and stock tax liability and beginning July 1, 1971, a national bank may credit the stock and deposit tax paid against its gross income tax liability. The exemption of dividends from stock of national banks from taxation was removed effective January 1, 1970, and national banks became liable for sales or use taxes on the purchase or lease of tangible personal property on December 24, 1969.

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stances in which any state other than that in which the principal office is situated may tax national banks, or other depositary institutions. Such a limitation should apply to taxes on net income, gross receipts, capital stock, and to other "doing business" taxes. The Board urges also that the law prescribe rules for such taxation. Third, says the Board, the law should prohibit the imposition of discriminatory tax rates on out-of-state depositary institutions. Fourth, the statute should make clear that coins and currency are intangible personal property for state and local tax purposes. Finally, the Board recommends that the federal public debt statutes be amended to authorize the states to include any income realized by banks and other depositary institutions from holdings of federal obligations as part of their taxable income subject to ordinary income tax.

Intangibles taxation

The ad valorem taxation of intangible property (that is, bonds, stocks, notes, and other claims, as well as money) has grown less common in the United States in recent decades. In good part, the gradual abandonment of this type of taxation by the states and localities reflects the extreme administrative difficulties that are commonly encountered. Avoidance of tax liability is accomplished quite easily, particularly by business firms engaged in multistate operations. Because holdings of bank deposits and other intangibles are highly mobile, taxpayers, quite understandably, are prone to seek tax shelter wherever it is to be found. Often, attempts to minimize or escape intangibles taxation take the form of outright evasion, as opposed to legally permissible avoidance. Because of the ease with which certain taxpayers are able to control the liability they incur under taxes on intangibles, effective rates of taxation on such property vary widely—a factor that has encouraged the abandonment of intangibles taxation as inequitable and inefficient.

Because the taxation of national bank intangibles—their holdings of reserve balances, interbank deposits, loans, and investments—has been forbidden down to the present by the terms of Section 5219, the extension of this prohibition would affect the states and localities only to the extent that it would deny them access to revenue that has not been available to them before now.

Perhaps the strongest argument for continuing the existing prohibition on state and local taxation of bank intangibles has to do with the vulnerability of the banks and other depositary institutions to a tax that would tend to pyramid with the multiple layering of claims. This is an inherent feature of an institutional structure designed to channel savings into investment. Deposits, loans, loan-backed obligations and certificates of interest in loans are illustrative of the several separate claims there may be to a single underlying source of income, or taxpaying "capacity." Clearly, the exposure of each of these individual claims to an intangibles tax would tend to discriminate against the process of financial intermediation in favor of the often less efficient direct movement of funds from savers to borrowers.

Another strong argument for continuing the ban on state-local taxation of intangibles comes from the possibility that the extension of such taxation to national banks would occur in a piecemeal fashion. Thus, while in some of the states the abandonment of intangibles taxation in general has long been complete, in others the use of this tax form has been ebbing only slowly. Given the urgency of state-local revenue needs, there is the likelihood that in some states, at least, a new effort might be made to tap this poten-

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Temporary provisions now in force

The accompanying article is concerned mainly with implications of the "permanent amendment" of the federal statute governing the taxation of national banks (section 2 of P. L. 91-156, amending "Section 5219"). This amendment is scheduled to take effect January 1, 1972, although proposals have been made for postponing this date. During the period extending from the date of enactment of P. L. 91-156 (December 23, 1969) up to the permanent amendment's effective date, the "temporary amendment" to Section 5219 (section 1 of P. L. 91-156) governs the taxation of national banks by the states.

The temporary amendment granted the states the power to apply any nondiscriminatory tax imposed generally, excepting a tax on intangible personal property, to national banks having instate principal offices, in the same manner as the states tax banks that they charter. In addition, the state legislatures were expressly permitted to extend generally applicable, nondiscriminatory sales and use, real property, documentary stamp, and tangible personalty taxes and fees to national banks headquartered outside their borders.

Section 3 of P. L. 91-156 requires that no state tax imposed under authority of law in effect before December 23, 1969 could be applied to banks during the term of the temporary amendment unless that tax had been applied to banks before December 23, 1969 or were made initially applicable to banks by "affirmative" legislative action after that date. This limitation does not in general apply, however, to sales or use taxes, documentary stamp taxes, or tangible personalty taxes.

tial source of revenue. If the move to tax national bank intangibles (and the intangibles of state-chartered banks and other depositary institutions as well) became a general one, the presumption is that market yields on the various forms of income-producing, bank-owned intangibles would tend generally to rise, although probably not sufficiently to compensate fully for tax costs. But if the move to intangibles taxation were selective, with relatively few states taking action, the impact on yields of intangibles would be commensurately less. The result could well be that banks and customers of banks situated in states adopting taxes on bank-owned intangibles would suffer competitively vis-a-vis banks and bank customers in states continuing to exempt such property.

The Board's proposal to extend national bank immunities to state and local taxation to state-chartered banks and other depositary institutions reflects a conviction that the state-local tax system should be neutral in its impact on financial institutions of a broad class. Tax differentials among the various kinds of depositary institutions would constitute a form of unneutrality tending to alter the allocation of resources among such institutions.

Out-of-state taxation

As it now stands, the permanent amendment to Section 5219 will enable the states to tax income earned within their borders by out-of-state institutions, beginning in 1972. Possibly differences will arise among the states with respect to the definition and measurement of taxable income and activity ascribable to interstate operations, and methods of dividing bank income between home states and other states having tax jurisdiction. In the Board's view, disagreement on these points could place national banks (and other financial institutions) in the same awkward

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position as mercantile and manufacturing firms doing business interstate. Despite extended study and debate over the past dozen years, Congress thus far has been unable to reach agreement on a satisfactory set of ground rules to guide the states in the tax treatment of interstate nonfinancial businesses. It would be desirable, therefore, to prescribe at the outset certain principles to be followed by the states in taxing financial institutions engaged in interstate business. The failure to do so could lead to the erection of obstructions to the free flow of funds across state lines, which, in turn, could have discriminatory effects upon borrowers and depositors endeavoring to do business with out-of-state financial institutions.

In the words of the bank taxation report:

> The Board's recommendation on out-of-State taxation is addressed to the problem of minimizing these barriers to interstate and interregional mobility of funds while recognizing also the congressional desire to minimize constraints on State taxing powers. It is intended to forestall the development of significant impediments to such mobility while safeguarding the authority of the States to collect taxes in circumstances where an outside bank or other depositary institution has established a clear relationship to the taxing State or political subdivision through a physical presence or a pattern of sustained and substantial operations. If the Board's proposals are adopted, States would not be limited in their choice of tax measures applicable to banks and other depositary institutions (except as to intangible personal property). But the circumstances in which these taxes would be applied to out-of-State institutions would be clearly defined and circumscribed and certain State procedures for applying taxes to out-of-State institutions would be standardized throughout the Nation.
>
> The Federal statute should establish uniform criteria for determining when a State or its subdivisions may exercise jurisdiction to tax a bank or other depositary institution which has its principal office or is chartered in another State; principles and procedures that will govern the interstate division of each type of applicable tax base in circumstances where the jurisdictional tests are met; and rules that will guide the States in their administrative procedures, such as the application of a unitary business concept, requirements of consolidated or combined tax returns from related or affiliated corporations, audits of out-of-State corporations, and other procedures. It may be desirable in such legislation to designate a Federal administrative agency to provide interpretations and regulations.
>
> Like the present Federal statute that applies to net income taxes on business involving interstate sales of tangible personal property (Public Law 86-272), the law relating to depositary institutions might provide that certain common occurrences do not, by themselves, constitute a sufficient connection with the State to establish jurisdiction to tax (e.g., mere solicitation of prospective borrowers by a depositary institution or its representatives, the loans being approved or rejected outside the State; the holding of security interests in property located in a State; or enforcement of obligations in the courts of a State). In establishing such criteria, the overriding objectives should be to avoid creation of tax impediments to the continued free flow of credit across State lines and uneconomic changes in the procedures that now govern the overwhelming bulk of interstate lending by depositary institutions.[3]

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[3]**Ibid.**, pp. 5-6.

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Other recommendations

The suggestion that Section 5219 should expressly prohibit the discriminatory tax rate treatment of out-of-state depositary institutions is consistent with an effort to forestall the erection of barriers to the free flow of funds geographically. Such a proposal probably will arouse little controversy, inasmuch as it purports to do no more than keep the treatment of in-state and out-of-state financial institutions on a parity.

The proposal to class coins and currency as intangible personalty would clear up confusion on a relatively minor point. In the past, these categories of property occasionally have been treated under the tax laws as tangible personalty. Making it mandatory that both coin and currency be classed as intangible personalty would lead to continuation of their tax-free status under state intangibles taxation, assuming that the Board's recommendations for exemption of intangibles receives congressional implementation.

The call for amendment of the public debt statutes to authorize direct state taxation of income on holdings of U. S. obligations received by depositary institutions is intended to end the artificial distinction between the direct taxation of corporate net income and the taxation of such income under the economically identical franchise or excise tax. The latter is a tax form devised to circumvent the immunity by expressly reaching total net income, including that derived from nominally tax-exempt securities. The emergence of the franchise tax device attests to the basic right of the states to tax nominally-exempt income. The measure proposed by the Board would amount essentially to a simplification of present practice.

Effective date

The measures proposed for further congressional action probably will call for careful and extended consideration. In the time remaining before the permanent amendment of Section 5219 is scheduled to take effect, it could be difficult to devise a set of satisfactory and acceptable amendments to the law. For this reason, the Board suggests that Congress might wish to postpone the effective date of the permanent amendment. This would extend the term of applicability of the temporary amendment, which is now in force, and thus essentially preserve the status quo until suitable new legislative action has been accomplished. Introduced in the Senate on July 22 and the House on August 3 were identical draft resolutions extending to January 1, 1974, the effective date of the permanent amendment to Section 5219. No action on these resolutions had been taken prior to mid-September.

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