THE PROPOSAL TO TAX INCOME FROM GOVERNMENTAL SECURITIES

II. THE CASE AGAINST TAXATION

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The issuance of tax exempt securities by federal, state and local governments has been condemned throughout the past few years by many persons of high position and considerable prestige. Various Secretaries of the Treasury have inveighed against the practice, and to their voices have been added those of four Presidents. A few professors and tax associations have also joined in the general clamor, and the recent *Fortune* and Gallup polls have indicated that over three fourths of the people of the nation believe the tax exempt bond should go. The National Program Committee of the Republican Party, headed by Dr. Glenn Frank, only a few weeks ago urged the abolition of the tax exempt feature from public securities, although throughout their report of over one hundred pages they nowhere considered the subject. However, after considerable study of the economic and fiscal material and the constitutional questions, and at the risk of being regarded as "a voice crying in the wilderness," the writer cannot but express his respectful dissent.

At the outset, it should be pointed out that the term "tax exempt" is in reality a misnomer, when applied indiscriminately to all public securities. Under our federated system, as presently interpreted by the Supreme Court, both the federal government and the states are sovereign and supreme within the scope of their powers and, ever since the great case of *McCulloch v. Maryland*,[1] it has been recognized that neither sovereign may interfere with the sovereign powers of the other. The power to borrow money is a sovereign power and its exercise by one sovereign may not be burdened or interfered with by the other, though the sovereign which issues the bonds, of course, has the right to tax them. Therefore, the bonds issued by the federal government are immune from state taxation, but merely exempt from

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[1] 4 Wheat. 316 (U. S. 1819).

federal taxation; while bonds issued by the states and their subdivisions, are immune from federal taxation, but merely exempt from state taxation. With this distinction in mind, we may therefore refer hereafter to such bonds as "tax exempt."

The arguments against tax exemption of public securities simmer down to four main points. It is claimed that such bonds are a means of tax avoidance by the wealthy, which necessarily results in a loss of tax revenue. Thus, a Treasury witness before the Ways and Means Committee of the House of Representatives stated that

"Tax exempt securities can—and do—afford opportunities of tax avoidance."[2]

Other representatives of the Treasury, and all proponents of the taxation of public securities, have consistently and continually reiterated the alleged fact that the tax exempt bond furnishes a refuge and a haven for the wealthy whereby they escape their just share of taxes. Unfortunately, however, the makers of this statement have never supported it with any tangible proof.

Secondly, it is claimed that investment in tax exempt securities interferes with the normal flow of risk capital. Former Under-Secretary Hanes of the Treasury stated:

"Enterprise involving risks finds it difficult to compete with tax-exempt securities in attracting capital from individuals in the higher income brackets. . . . The logical sources for much of the needed venturesome capital is the surplus funds of persons in higher income brackets. The existence of tax exempt securities, however, constitutes such an attractive alternative opportunity for these persons that it diverts needed funds from private investment."[3]

Thirdly, it is claimed that the existence of tax exempt bonds destroys the progressiveness of the income tax. In his message of April 25, 1938, President Roosevelt said.

"A fair and effective progressive income tax and a huge perpetual reserve of tax exempt bonds cannot exist side by side."

Another former Under-Secretary of the Treasury states:

"Progressive surtaxes cannot be made to operate effectively so long as governments themselves provide this easy mode of escape from them."[4]

[2] Statement of John W. Hanes, Under-Secretary of the Treasury, *Hearings before the House Committee of Ways and Means*, 76th Cong., 1st Sess. (1939) 449. The same witness stated before the Special Senate Committee, appointed to study the question of intergovernmental taxation, "Some persons with large incomes are able to escape income taxes entirely, or in large part, through the device of tax exempt securities." *Hearings before the Special Senate Committee on Taxation of Government Securities and Salaries*, 76th Cong., 1st Sess. (1939) 5.

[3] *Ways and Means Committee Hearings*, 451. The Chief Counsel of the Bureau of Internal Revenue declaims that: "The most promising source of risk capital is the savings of individuals in higher income brackets, but the policy of extending tax exemption to public securities attracts much of this capital instead to a practically riskless field which might much better be filled by the savings of persons less able to afford to take a chance. . . . Thus it would appear that the effect of the existence of tax exempt bonds upon the business life of the country is decidedly bad." Address by John Philip Wenchel before the Investment Bankers Ass'n of America, White Sulphur Springs, W. Va., Oct. 26, 1938.

[4] Magill, *The Problem of Intergovernmental Tax Exemptions*, NAT. TAX ASS'N PROCEEDINGS, 1937, p. 388, at p. 393.

Fourthly, it is contended that the tax exempt feature of public securities permits governments to borrow more easily than they would be able to were their securities taxable, and, therefore, promotes public extravagance.

These arguments are unquestionably plausible. So plausible, in fact, that too many people have accepted them at face value without bothering to investigate the facts and premises upon which they rest. It is our belief that a thorough examination of these arguments reveals that they are indeed plausible, but unfortunately untrue.

Dr. Harley L. Lutz, Professor of Public Finance at Princeton University, and a recognized expert in this field, has recently undertaken a comprehensive study of this entire question, at the request of Comptroller Morris S. Tremaine of the State of New York. His report to the Comptroller, entitled "The Fiscal and Economic Aspects of the Taxation of Public Securities,"[5] completely reexamines the entire situation in the light of actual available figures. This report is doubly interesting because the author has stated that when he began his studies he had the preconceived notion that the tax exempt bond should be abolished.

Dr. Lutz concludes in his report that the arguments against the tax exempt bond are not founded in fact; that if public securities are subjected to reciprocal federal and state taxation the only fiscal result will be a net loss to the nation as a whole, together with a shifting of revenue to the federal government at the expense of the states. Although the studies of Dr. Lutz were entirely original, it is interesting to note that he arrives at conclusions similar to those expressed by Dr. Charles O. Hardy of the Brookings Institution, in a study made in 1926.[6] The earlier study, however, was handicapped by the fact that there were not available to Dr. Hardy the figures which would seem to establish that the tax exempt bond, far from being a means of tax escape, is in reality a means of tax saving, not to the wealthy, but to the smaller, taxpayer.

It is simply not the fact that the wealthy are loading their estates with tax exempt bonds in order to escape their just share of income taxes. An examination of all estate tax returns filed with the Treasury Department in the calendar years 1927-1937 inclusive, reveals somewhat startling figures. These are not selected estates, nor a sampling, but are all the estates reported for tax purposes during those eleven years. During the period noted above there were 3,044 estates having a net worth of $1,000,000 or more. There were 105,499 estates of less than $1,000,000 net. Of the estates above $1,000,000, totaling over ten and one-half billion dollars, the following were the percentages of investment:[7]

Wholly exempt federal bonds	3.69%
Partially exempt federal bonds	1.12%
State and local bonds	9.81%
Taxable corporate bonds	4.80%
Corporation capital stocks	55.23%

[5] Privately printed (1939), hereinafter cited as the "LUTZ REPORT." Copies of this Report are available in the Library of Congress and at most of the prominent libraries throughout the country.

[6] TAX EXEMPT SECURITIES AND THE SURTAX (1926). [7] LUTZ REPORT, 46.

For the estates less than $1,000,000 totaling twenty-two billions, the following were the ratios:

Wholly exempt federal bonds	1.05%
Partially exempt federal bonds	2.46%
State and local bonds	3.61%
Taxable corporate bonds	8.46%
Corporation capital stocks	36.14%

The average for all estates:

Wholly exempt federal bonds	1.90%
Partially exempt federal bonds	2.03%
State and local bonds	5.63%
Taxable corporate bonds	7.27%
Corporation capital stocks	42.35%

It will be noted that the average ratio of all public securities to the gross estate is 9.56% while the average ratio of all private securities to the gross estate is 49.62%, and that the amount of taxable corporate bonds is almost equal to the percentage of all public securities, being 7.27%. Moreover, as far as holdings of state and municipal bonds are concerned, taxable corporate bonds exceed them by almost three to two, since taking both the large and small estates, municipals constitute only 5.63% of the security holdings.

These figures hardly bear out the constantly repeated plaint of Treasury officials that the wealthy are escaping taxes by sinking their funds in tax exempt bonds, and also shed considerable light on the consistent failure of Treasury spokesmen to offer tangible statistics, rather than generalities, in support of their argument.

Many people, when confronted with these figures, are inclined to be skeptical and exclaim, "Well, if the rich don't take this way of escaping taxes, why don't they?" The answer is relatively simple. While it is unquestionably true that there are a certain few rich persons who do profit by investment of capital funds in tax exempt bonds, no one ever got rich buying tax exempts. The vast majority of large incomes made today in the United States necessitate the investment and continuance of capital in private enterprise. Perhaps one of the best commentaries on this phase of the question comes from a witness produced by the Treasury Department at the Senate Hearings, Professor William J. Shultz, of the College of the City of New York:

"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 man who can afford to own them."[8]

Moreover, the number of people in the high surtax groups who can benefit from the ownership of tax exempt securities is small. If the income be entirely from tax

[8] *Special Senate Committee Hearings*, 534.

free securities, it would have to be more than $60,000 a year before the investor begins to gain on the basis of the average interest yield spread between comparative public and private investments in 1938. In the year 1936 there were only 12,975 returns of net incomes in the brackets of $60,000 and over.[9] To achieve such an income on the basis of the investment of capital in a 2% tax exempt bond, it would first be necessary to find $3,000,000 in cold cash.

Where there is a mixed income from both taxable and nontaxable sources, the breaking point of advantage in holding tax exempt securities drops to the net income level of approximately $20,000. However, the relative gain from such investments by persons whose net incomes may be between $20,000 and $60,000 is not large and it becomes smaller in proportion as the income itself diminishes.[10]

Moreover, it must be remembered—and this is almost universally overlooked—that when an investor purchases a tax exempt bond he accepts a very low rate of interest, which is in effect a form of taxation at the source. The investor is paying a tax to the borrowing body, be it federal, state or municipal, which is frequently more than he would pay in the form of income tax had the bond been taxable and borne a comparable interest rate.

The Treasury Department insists that the issuance of tax-free securities interferes with the normal flow of risk capital, but capitalization figures do not bear out this statement. In the five years from 1926 to 1930, corporate assets increased seventy-three billion dollars. During this same five years the secured debt borrowed in private industry increased by almost twenty billion dollars. State and local borrowing was not more than seven billion dollars at most during this same period, while there was no federal borrowing, since the federal debt was being retired. In the five years from 1930 to 1936 the influence of the depression had its effect and the total corporate assets remained approximately the same. But neither was there any appreciable state and local borrowing during this period, since it averaged less than $10,000,000 a year.[11] Therefore, the failure of capital corporate assets to increase obviously cannot be blamed on state and local borrowing, since there was none. If there has been a diversion of capital funds from industry since 1932, it might be well to look to the federal program of borrowing and to the federal surtax rates. As has been pointed out before, the federal government can tax its own bonds any time it wants to, and if its officials are so convinced that this is the remedy, it is somewhat incongruous that they are not willing to try it on their own dog first.

Moreover, general business conditions, as such, played a far greater role in the absence of risk capital than the issuance of tax free securities. Mr. Hanes himself was quoted as saying, on September 17, 1939:[12]

"That he was 'optimistic' on the business outlook because the 'profit motive is returning,' whereas, in the last five years people were 'concerned chiefly with safety.'

". . . As a result of the quickening of public confidence, the Under-Secretary said, business executives are now more freely putting accumulated company funds into plant

[9] LUTZ REPORT, 130-132.
[10] *Ibid.*
[11] LUTZ REPORT, 155.
[12] *New York Times*, Sept. 17, 1939, I, 13.

equipment and improvement. He contrasted this with the fact that not so long ago some government obligations were quoted at a minus interest rate.

" 'In other words,' he said 'people were paying the government money to keep their funds safe.' "

It seems somewhat difficult to square this statement of the former Under-Secretary with the continued insistence upon the tax avoidance argument. If the investor's primary concern is safety, then the taxability of the income makes little difference. Moreover, the capital invested by trustees, insurance companies, and other institutional investors, and by public funds such as retirement systems, sinking funds, and so on, is not risk capital in any event and it is such investors who hold two thirds to three fourths of the outstanding public securities. Such investors are not interested in tax avoidance because they are not subject to the surtax. They are forced by legal limitation to invest in public securities and would do so whether they are tax exempt or not. The only difference would be that it would cost the borrowing body far more in interest than it does at present.

Nor does the issuance of tax free securities destroy the progressiveness of the income tax. The income tax, at present, seems to be working very well. Dr. Lutz, in a recent lecture, aptly illustrated this fact. He stated:[13]

"In 1937, in the net income brackets of $60,000 and over, there were 11,529 returns reporting a total net income of $1,412,936,000, upon which a total tax of $575,918,000 was paid. In the brackets between $20,000 and $60,000, there were 67,725 returns reporting a total net income of $2,115,373,000, upon which a total tax of $278,282,000 was paid.

"These figures indicate that in 1937 there were 11,529 persons who could have benefited from tax exemption by converting *all* other investments into tax-exempt securities. That is, they received a net income of $60,000 or more. On the basis of the 1938 yield differential, these were the only persons who could have gained by such a course from the standpoint of tax savings. Yet this small group of individuals did not convert everything into tax-exempts. On the contrary, they reported total net income of $1,412,936,000, on which taxes were paid amounting to $575,918,000. This group represented .18% of the total number of returns filed, and their income was 6.7% of aggregate net income reported, yet the tax paid was 50.4% of the total personal income tax for the year. Apparently there is little avoidance of income taxation here, and no failure of the progressive system.

"Similar, though less extreme, progression appears in the case of those in the income brackets $20,000 to $60,000. The individuals in these income brackets comprised 1.07% of all who made returns; they had 10% of total net income reported; and they paid 24.4% of the total tax. Again the progressive tax system appears to be in good working order despite the possible receipt of some income from tax-exempt sources.

"The Treasury's reply to these figures was a suggestion that those persons also had so much income from tax-exempt sources as to create a serious menace to the progressive tax system. One witness before the Special Senate Committee put it as follows:[14]

" '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

[13] Lutz, *The Business Man's Stake in Government Finance*, THIRD ANNUAL STANFORD BUSINESS CONFERENCE, July 17-21, 1939.

[14] *Special Senate Committee Hearings*, 584.

an undetermined amount—constitutes a serious threat to the progressiveness of income tax.'

"Regardless of the amount of tax-exempt income that the individuals with net incomes of $20,000 and over may have received, the hard fact remains that on one-sixth of total personal net income they paid three-fourths of the personal income tax. With this kind of actual progression, it is an exaggeration to say that the progressiveness of the income tax is seriously impaired."

The argument that the tax exempt bond fosters municipal extravagance ignores the meaning of the word extravagance. Extravagance means disregard of cost, and if municipal officials are extravagant, they will be so, whether their securities are taxable or not. The place to stop extravagance is at the ballot box, not by making confusion worse confounded by increasing the cost of what is assumed to have already cost too much.

Moreover, while unquestionably there was some extravagance during the period 1926-1929, the "era of beautiful nonsense," in large part the borrowings of states and cities have been demanded by their citizens to solve problems which have only recently become the concern of government. The rapidly mounting hazards of motor traffic demand large expenditures which cannot be ignored. The need for low cost housing has been recognized as one of pressing public importance. Schools, health centers, relief, recreation, parks, rapid transit, all of these have made demands upon state and local government within the last twenty-five years far in excess of any demands made upon it heretofore. It is for these purposes that state and municipal borrowing has been incurred and will be incurred in the future.

Having considered the arguments against the tax exempt bond and the answers to them, let us consider the actual fiscal effects of the reciprocal tax proposal.

The Treasury Department advocates the imposition, by legislation, of a federal tax on all federal, state and municipal securities to be issued in the future together with a permission contained in the legislation to the states to levy a tax upon federal bonds.

It is the unanimous opinion of fiscal experts throughout the country, including experts of the Treasury Department, that this proposal would immediately cause a rise in the interest rate paid on public securities, since the buyer would refuse to absorb the tax, but would pass it on to the borrower. Moreover, the rise in interest demanded by the purchaser has been proven by actual experience to be more than would ordinarily compensate for the tax imposed upon the income from the bonds.[15] Comptroller Tremaine of New York explains this apparent paradox:

[15] City of Easton, Pa., passed on to purchaser a 4-mills state tax on its municipal bonds. Resulting rise in interest rate was ten mills or 2½ times the tax. Statement of Norman A. Peil, Director of Accounts and Finance, Easton, Pa.; *Special Senate Committee Hearings*, 276.

In Ohio, various cities issued both tax-free and taxable bonds. The average interest spread between the two was 75 points. For example, Cincinnati tax-free bonds were offered on a 1.25% basis, while Cincinnati taxable bonds were selling around 2%. Statement of W. E. Kershner, Secretary, State Teachers Retirement System, Columbus, Ohio; *id.* at 369.

See also statement of Comptroller Morris S. Tremaine of New York State, *id.* at 203.

"Why does the market adjust itself to the tax differential with such a wide margin to spare? The answer is simple. The purchaser of a bond maturing say, 20 years hence, naturally does not know whether the current 5-percent tax will continue to obtain or whether it may be raised to 10 percent, or 15 percent, or some other percentage before his investment is finally retired. So, in the face of this uncertainty, the purchaser naturally hedges on the price in an endeavor to cover any possible future eventuality."[16]

Dr. Lutz, in his study, estimates that the rise in the interest rate on first grade state and municipal long term bonds would be 60 points, and that the rise on short term borrowings would be 20 points. This, of course, would vary according to the strength of the bond. As to federal bonds, Dr. Lutz estimates an average rise of about 7 points on both long-term obligations and short-term notes.[17]

The bases for these estimates are too complicated to be set forth here. But suffice it to say that the conclusions of Dr. Lutz are supported by every municipal finance officer in the country, as well as by fiscal experts, municipal bond bankers and technical advisers. Comptroller Tremaine testified that:

"If Doctor Lutz has erred at all in arriving at his conclusions, it would be on the side of conservatism. His estimates on the increased cost of financing, I believe, are far lower than they would prove to be in actual practice."[18]

On the basis of Dr. Lutz's estimate of additional interest cost, the federal tax on state and municipal bonds would result in an increased interest cost[19] to the states and municipalities of $113,000,000 annually. The federal tax on federal bonds would result in an increased interest cost to the federal government of $157,000,000 annually, and the state tax on federal bonds would add an additional cost of $30,000,000. The states would gain from taxation of federal bonds only $17,000,000 annually. The federal government would gain from the tax on state and municipal bonds approximately $120,000,000 and on the tax on its own bonds $109,000,000. It will be noted that, in each case where the gain and loss are comparable, the additional interest cost always exceeds the revenue gained.

[16] *Id.* at 203.

[17] LUTZ REPORT, 68-69.

[18] Mr. Tremaine estimates a 75 to 100 point rise on the obligations of the State of New York, which are able to command a very low interest rate. *Special Senate Committee Hearings*, at 203.

Henry F. Long, Commissioner of Corporations and Taxation of Massachusetts, testified that at the very minimum the tax exempt feature of municipals represents a benefit to the issuing body of one half of one per cent. *Ways and Means Committee Hearings*, 445.

For other testimony to like effect by state and municipal financial officials, professors of finance, and bankers, see *Special Senate Committee Hearings*, 254, 331, 332, 365, 367, 385; *Ways and Means Committee Hearings*, 149, 152, 159, 165, 360.

Professor William J. Shultz, a Treasury witness, testified: "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." *Special Senate Committee Hearings*, 533.

Moreover, Professor James D. Magee of New York University stated in a recent study published by the Brookings Institution: "The cost of new government borrowing would be materially increased. In view of the fact that the credit of municipalities is none too satisfactory, such an increase in the cost of credit might in many instances have serious repercussions." TAXATION AND CAPITAL INVESTMENT (1939) 59.

[19] The following figures of annual additional interest cost assume the issuance of a volume of taxable bonds equal to that of presently outstanding nontaxable bonds. It is estimated this process of gradual replacement of nontaxable bonds will take about 40 years.

The composite result, therefore, shows that while the federal government stands to gain somewhat in revenue, the loss to the states far exceeds that gain. The states will lose $96,000,000 annually, while the federal government will gain only $42,000,000. Thus the nation as a whole—and it is well to remember that we are all citizens of both state and federal governments—will lose $54,000,000 annually.[20]

These figures by Dr. Lutz are substantiated in large part by those presented by the Treasury Department at the recent Senate and Ways and Means Committee Hearings.[21]

It is well to remember, also, that while the impact of the tax will immediately affect the interest rate which public securities must bear, the revenue to be received will be relatively inconsequential for at least twenty or more years to come, since sufficient tax-exempt bonds will remain outstanding for at least that period. The Treasury has many times conceded that the revenue, if any may be expected, will be an unimportant figure for years to come.[22]

The question naturally arises—"If this tremendous sum is lost between state and federal governments, who gets it and who pays it?" The answer is, of course, that the bondholder receives this sum in the form of extra interest, which more than compensates him for the tax he pays and thus overbalances the revenue received. Since the governments must pay it, naturally they must look to their only source of revenue—the taxpayer—to recoup it. Thus, the incidence of this tax falls directly on the general taxpayer—the real estate owner, the salaried employee, the home owner, the storekeeper, and similar classes of taxpayers who are least able to afford it. Thus the tax which is widely hailed as a "soak-the-rich" tax is, in reality, nothing but an added burden placed directly on the shoulders of the little fellow.[23]

Thus, it is obvious that the reciprocal tax will simply result in a shifting of revenue from the states to the federal government, with a net loss to the nation as a whole resulting, and the general taxpayer bearing the burden of this loss. Obviously, the loss to the states and cities will have to be made up by increased general taxation. The municipalities will have to levy additional taxes upon already overburdened real estate, and the states, already frantically searching for new sources of revenue,

[20] It is interesting to note that former Under-Secretary Roswell Magill estimated the federal revenue from a tax on state and municipal bonds to be $70,000,000 annually. Using this estimate of revenue, the net loss to the nation as a whole would be $104,000,000 annually, with neither the state governments nor the federal government showing anything but a loss. [21] *Ways and Means Committee Hearings*, 46.

[22] See *Senate and House Committee Hearings, passim.* Professor William J. Shultz has gone so far as to suggest that to prevent loss of revenue, and the investment of large fortunes in presently outstanding bonds, that even bonds already issued with a representation that they were tax exempt be taxed. *Special Senate Committee Hearings*, 544. The Treasury, however, expressly disclaims any intent to tax such securities. Statement of Under-Secretary John W. Hanes, *Ways and Means Committee Hearings*, 448.

[23] "If it is the intent to soak the bloated bondholder, this proposal is certainly not the way to achieve that end. On the contrary, it would tend to play into his hands at the expense of the ordinary local taxpayer. . . . Who pays this price differential, represented by the extra interest cost plus whatever margin of safety the market may dictate? Certainly not the bondholder. He is obviously benefited by the extra net income. The only person who must pay it is the ordinary tax payer in the municipality concerned, upon whose property the excess cost must be levied." Statement of Comptroller Morris S. Tremaine of New York State, *Special Senate Committee Hearings*, 203.

will find it necessary to tap even additional sources—if any are left—to recoup their additional borrowing expenses.

Moreover, this tax, with its concomitant rise in interest rate, will make refunding by states and municipalities virtually impossible. There are now in progress, and have been for the past two or three years, refunding programs of state and local governments, by reason of which vast sums were saved to local taxpayers. The City of Detroit, for example, refunded 4's and 4½'s at an interest rate which has saved the city almost $3,000,000 a year.[24]

Revenue bond financing, which has recently increased and which is recognized as a most desirable means of financing self-liquidating public undertakings, would be definitely crippled, if not altogether destroyed. The largest part of the cost of a self-liquidating undertaking is the interest on the funded debt, and, if this interest rate rises, the cost of maintaining a project will go so high that it cannot be floated on a self-liquidating basis and, therefore, in most cases, cannot be floated at all.[25]

The proposed tax is justified by its proponents on the ground that since it is reciprocal the states will be able to recoup any losses they may sustain by the taxation of federal bonds. The figures of Dr. Lutz show that this is a fallacy. Moreover, even the theory of reciprocity is a false one. The federal government would tax the states on the basis of the claim that it has the supreme constitutional power to do so, and therefore taxes the states as a matter of right. But the states will tax federal bonds because the federal government is graciously pleased at the moment to permit them to do so, and therefore the states tax as a matter of sufferance. Obviously, the permission granted by the federal government may be revoked at any time, but the power to tax the states, once established, cannot be taken away without a constitutional amendment.

Also, aside from the legal viewpoint, the reciprocity offered is an economic fiction. The municipalities of the country would receive no relief from the burden imposed upon them by a federal tax on their securities, since in almost all cases cities have no power to assess income taxes, and federal bonds would not be subject to a property tax. Moreover, even as regards the states, only Delaware, Massachusetts, New York and Wisconsin would stand to break even. These states might possibly show a slight profit because of the heavy concentration of federal bonds within their borders. All the other states, because of the unequal distribution of federal securities, and especially the twelve states which have no personal income tax and therefore would be unable to tax the federal securities at all, would have no chance of recoupment.

[24] Statement of Henry Hart, Vice President, First of Michigan Corporation, *Ways and Means Committee Hearings*, 150.

[25] Statement of Frank C. Ferguson, Chairman of The Port of New York Authority, *Special Senate Committee Hearings*, 254 *et seq.*; statement of Robert Moses, Chairman of the Triborough Bridge Authority, *id.* at 285: "It was necessary in each case to convince the investing public that these projects would be self-liquidating. In that connection it was vital that the interest rate be kept as low as possible. From my experience in negotiating the sale of these revenue bonds I feel positive that if the investing public were not convinced that they were exempt from Federal and State income taxes, the bonds probably could not have been sold at all and funds would not have been obtained for these vital public improvements without resorting to taxation and large Government subsidies."

Thus it is that the officials of the states and cities are universally opposed to the enactment of legislation subjecting state and municipal bonds to federal taxation. The Attorneys General of 45 states, together with other state and municipal officials, have banded together in a Conference on State Defense to fight such federal invasion of their fiscal autonomy. In this fight, they have the support of the United States Conference of Mayors, led by its President, Mayor Fiorello H. LaGuardia of New York, the American Municipal Association, the Municipal Finance Officers Association of America, the Municipal Leagues in every state in which they exist, the National Association of Attorneys General, and many other organizations in the field of public affairs.

All of these bodies are non-partisan and non-political, and have no ax to grind. All of them sent representatives to appear before the Senate and Ways and Means Committees, in 1939, to register the protests of the states and cities against the incalculable harm to which their finances would fall victim were this federal tax imposed upon them. Though witnesses representing every state in the country and most of the cities of the nation appeared before these committees, not one spoke in support of the Treasury proposal. It is therefore obvious that the considered opinion of those whose duty it is to know, is, that the proposed tax is unfair, unwarranted, and fraught with grave constitutional dangers.

These dangers center principally around the proposal to impose such a tax by Act of Congress. It is difficult, of course, in the field of constitutional law, and especially in the field of intergovernmental taxation, to give a flat "Yes" or "No" answer to any specific problem. It is unfortunately true that, with the Supreme Court as presently constituted, the value of precedent has considerably diminished. The Department of Justice alludes to this when, in admitting that the law as it now stands prevents the imposition of such a tax, it states:

"There remains only the bare fact that the *Pollock* case has been decided and that it has not yet been overruled. At least in the field of intergovernmental tax immunity, this is not a matter of great importance."[26]

Whether or not the Supreme Court is flattered by the statement that its existing decisions are not a matter of great importance is not known, but it is unquestionably true that the statement today has considerable validity. Since, however, the only way in which a legal opinion can be formulated is by a reference to the prior decisions of the court, we shall have to struggle along on that basis. The case of *Pollock v. Farmers' Loan and Trust Co.*[27] is the case which held that a federal income tax upon the interest from state and municipal bonds could not be constitutionally imposed by legislation. Since that case was decided, its validity has never been questioned by the Supreme Court but, on the contrary, its principles have been reiterated and upheld.[28] On the basis of precedent, therefore, we may conclude that such legislation should be held invalid.

[26] U. S. DEP'T OF JUSTICE, TAXATION OF GOVERNMENT BONDHOLDERS AND EMPLOYEES (1938) 61.
[27] 157 U. S. 429 (1895); 158 U. S. 601 (1895).
[28] Plummer v. Coler, 178 U. S. 115, 117 (1900); Ambrosini v. U. S., 187 U. S. 1, 7 (1902); Farmers

Moreover, even under the recent cases upholding reciprocal taxation of public salaries,[29] legislation taxing state and municipal bonds would nevertheless be invalid under the rules therein postulated. In the *Gerhardt* case, the court laid down the rule that a tax would be upheld unless there was an actual burden upon or interference with the functions of the state. Moreover, the burden must be real and direct and not merely "speculative and conjectural." This rule was reiterated in the *O'Keefe* case.

If this rule be applied to our present problem, there seems no escape from the conclusion that the tax is invalid. A tax which will impose an expense of over a hundred million dollars a year upon the states and municipalities is certainly not a burden merely "speculative and conjectural." Such a burden is real and direct. Such a burden, moreover, would definitely operate to hamper the exercise of the sovereign power of the states to borrow money. If these statements are true, and they may readily be proved, then the tax may not be upheld.

It is also urged that the adoption of the Sixteenth Amendment to the Constitution has given the federal government the power to tax "income from whatever source derived," and that such income includes the income from state and municipal bonds. To so construe these words, it is necessary to wrench them from their context, and to ignore entirely the reason for the enactment of the Amendment. The Sixteenth Amendment was intended only to overcome the provision of the Constitution which requires that any direct tax be apportioned among the several states according to population. This provision made an income tax impractical and unworkable and therefore the Sixteenth Amendment was adopted in order to allow the practical operation of a personal income tax.

Moreover, many Supreme Court cases have held that the Sixteenth Amendment does not encompass within its scope the income from state and municipal bonds.[30] It is true that Mr. Justice Black has suggested the desirability of a reexamination of the subject,[31] but his colleagues have so far shown no inclination to follow his lead.

& Mechanics Savings Bank v. Minnesota, 232 U. S. 516, 526-527 (1914); Evans v. Gore, 253 U. S. 245, 255 (1920); Gillespie v. Oklahoma, 257 U. S. 501, 505 (1922), *over'd on other grounds*, Helvering v. Mountain Producers Corp., 303 U. S. 536 (1938); Greiner v. Lewellyn, 258 U. S. 384, 386 (1922); Metcalf & Eddy v. Mitchell, 269 U. S. 514, 521, 522 (1926); National Life Ins. Co. v. U. S., 277 U. S. 508, 521 (1928); Willcuts v. Bunn, 282 U. S. 216, 225, 226 (1931); Indian Motorcycle Co. v. U. S., 283 U. S. 570, 577; (1931); Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 400 (1932), *over'd on other grounds*, Helvering v. Mountain Producers Corp. 303 U. S. 376 (1938); Trinityfarm Construction Co. v. Grosjean, 291 U. S. 466; 471 (1934); Ashton v. Cameron County Water Imp., Dist. No. One, 298 U. S. 513, 530 (1936); New York *ex rel.* Cohn v. Graves, 300 U. S. 308, 315, 316 (1937); Hale v. Iowa State Board, 302 U. S. 95, 107 (1937); James v. Dravo Contracting Co., 302 U. S. 134, 150, 153, 156 (1937); Helvering v. Mountain Producers Corp., 303 U. S. 376, 386 (1938); U. S. v. Bekins, 304 U. S. 27, 52 (1938); Helvering v. Gerhardt, 304 U. S. 405, 417 (1938).

[29] Helvering v. Gerhardt, 304 U. S. 405 (1938); New York *ex rel.* O'Keefe v. Commissioner, 306 U. S. 466 (1939).

[30] Brushaber v. Union P. R. Co., 240 U. S. 1 (1916); Stanton v. Baltic Mining Co., 240 U. S. 103 (1916); Peck & Co. v. Lowe, 247 U. S. 165 (1918); Metcalf v. Mitchell, 269 U. S. 514, 521 (1926); Evans v. Gore, 253 U. S. 245 (1920); Willcuts v. Bunn, 282 U. S. 216 (1931); Eisner v. Macomber, 252 U. S. 189 (1920); National Life Insurance Co. v. U. S., 277 U. S. 508 (1928).

[31] Concurring opinion of Mr. Justice Black in Helvering v. Gerhardt, 304 U. S. 405, 424 (1938).

In closing I should like to quote from a recent address of the Solicitor General of the State of New York. He said:

"But I would like to point out to you just exactly what this argument of the Treasury means. They insist that the Sixteenth Amendment means what it says, and exactly what it says. If this be true, then income of any sort is subject to a federal tax. Income from municipal water supply systems, from a municipal electric light plant, from publicly owned toll bridges, from myriads of other public enterprises, is therefore taxable. The very tax revenues of the states and municipalities themselves are income—and therefore taxable —if Washington wishes to do so.

"Thus we come to the crux of the situation. Grave problems of governmental effectiveness flow from the sovereignty that is bound up with 'tax immunity.' There is latent in the attempt by the Federal Government to tax the exercise of the governmental powers of the states, a most serious danger to traditional American institutions of state and local home rule and of a surrender to what may become concentrated nationalism.

"This proposal attempts to brush aside the whole history and meaning of our state and local institutions. This we must resist to the utmost of our ability. The consequences are too dangerous, both in governmental principles and in fiscal effects to warrant the change. In the words of the Mayor of New York, 'The proposal comes one hundred and fifty years too late.'"