Volume Title: The Ownership of Tax-Exempt Securities, 1913-1953

Volume Author/Editor: George E. Lent

Volume Publisher: NBER

Volume ISBN: 0-87014-361-1

Volume URL: http://www.nber.org/books/lent55-1

Publication Date: 1955

Chapter Title: The Volume And Composition Of Tax-Exempt Securities Outstanding, 1913-1953

Chapter Author: George E. Lent

Chapter URL: http://www.nber.org/chapters/c6455

Chapter pages in book: (p. 15 - 42)

2

The Volume and Composition of Tax-Exempt Securities Outstanding, 1913–1953

State and Local Securities

The sovereignty of the states and the federal government has always presented a problem in their fiscal relationships. In the historic decision of *McCulloch v. Maryland*,[1] the Supreme Court unanimously upheld the supremacy of the United States against the taxation of its instrumentality, the Bank of the United States. "That the power to tax involves the power to destroy," it declared, is a proposition "not to be denied." It was not until 1895 that a unanimous decision in *Pollock v. Farmers' Loan and Trust Company* confirmed a similar immunity with respect to federal taxation of interest on state and local securities.[2]

Adoption of the Sixteenth Amendment cleared the way for the federal income tax which was enacted October 3, 1913. Despite the grant of authority to tax income "from whatever source derived," there remained considerable doubt over the applicability of the amendment to interest on state and local securities. To avoid raising any further controversy on this score, Congress ex-

[1] 4 Wheat. 316 (1819).

[2] The Court first held that the federal tax was "a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution" [157 U.S. 429 (1895)]. Upon rehearing, the Court affirmed its previous conclusion, not by reason of the immunity doctrine, however, but on the ground that such taxes were required to be apportioned in accordance with Art. I, Sec. 8, of the Constitution [158 U.S. 601 (1895)]. See Dept. of Justice, *Taxation of Government Bondholders and Employees,* 1938.

pressly exempted such income from tax, together with salaries of state and local officials.[3]

Gross Obligations of All Units. The turn of the century witnessed the beginnings of a great upsurge in state and local borrowing.[4] Between 1902 and 1913 gross state and municipal debt expanded twofold, from $2.2 billion to $4.5 billion. Such borrowing was retarded somewhat by wartime restrictions and credit conditions, but by 1922 gross debt again doubled to $10 billion and by June 30, 1932, redoubled to $19.6 billion (Table 2).[5]

The expansion of state and local debt prior to 1932 reflected the rapid social and technological changes then taking place in the nation, as well as the steady increase in population and urbanization which accompanied the growing economy. Outlays for public roads and schools together accounted for at least half of the borrowing. Public-service enterprises, such as sewer systems, water supply, power and gas utilities, harbors and docks, and drainage and irrigation, made up a third important category. Of considerably less importance was borrowing for hospitals and other welfare institutions, other public buildings, parks and playgrounds, and libraries and museums.

This era of expansion came to a close with the Great Depression, when state and local debt leveled off at $19–$20 billion. Rigid governmental costs and sharply declining revenues caught many localities in a financial squeeze which threatened their solvency. Defaults in payment of interest and in meeting maturities on existing debts impaired municipal credit and limited borrowing for capital improvements. New local borrowing tended to be offset by the retirement of old loans. The states were less severely affected, however, and continued to increase their net borrowing,

3 Representative Cordell Hull explained that "it was not the desire of those who have been taking the most active interest in this measure to inject any more constitutional questions or controversies into the bill, especially for the sake of only a few thousand dollars in taxes." *Congressional Record,* 63d Cong., 1st sess., 1913, p. 1262.

4 A. M. Hillhouse, *Municipal Bonds—A Century of Experience* (Prentice-Hall, 1936), pp. 31–37.

5 A portion of the gross debt was held in sinking funds and trust accounts of state and local governments. See Chap. 3 for a description of these holdings.

largely to meet relief payments and other emergency requirements.[6]

World War II brought about the first major reversal in the volume of state and local securities outstanding. Between 1942 and 1946 the gross debt declined from $19.7 billion to $15.9 billion. This drop may be attributed both to the wartime curtailment of public construction and to the improvement in government revenues, which better enabled borrowers to redeem their debt.

The end of the war marked the beginning of another area of expansion. Wartime postponement of capital expenditures, as well as the growth and shifting of population, intensified requirements for schools, highways, and public works. State financing of veterans' bonuses and local financing of public-housing projects superimposed additional demands for public loans. Within seven years, by June 1953, gross state and local debt rose to $32.1 billion.[7] Except for a nominal amount of federal bonds these state- and local-government securities now constitute the entire supply of wholly tax-exempt securities available for public and private investment.

Origin and Purpose by Unit of Government. Although greatly exceeded by that of local governments since 1913, state debt has tended to increase in relative importance (Table 2). During the expansion phase 1913–1932 the proportion of state debt increased from 9.4 per cent to 14.8 per cent of the total and in 1940 attained a maximum prewar ratio of 17.4 per cent. More than half of this debt was incurred for highway construction.[8]

State borrowing contracted during the war but then increased threefold to almost $7 billion in 1952, when it reached almost one-fourth of the total. A substantial part of the postwar increase was incurred for payment of veterans' bonuses, and by 1952 such obli-

6 Hillhouse, *op. cit.*, Chap. IX; Dept. of Commerce, *Long Term Debts in the United States*, 1937, pp. 179–84.

7 Exclusive of territories and possessions. Gross debt of the possessions and territories, for which special exemption has been provided by law, has never exceeded $165 million. The volume grew from $30 million in 1913 to about $160 million by 1927, where it remained until 1932. Between 1941 and 1947, such tax-exempt obligations declined to less than $50 million. The major drop, between 1946 and 1947, resulted from the granting of independence to the Philippine Islands and the loss of its tax privileges.

8 Bureau of the Census, *Financial Statistics of States, 1919* and *1940*.

TABLE 2

GROSS DEBT OF STATE AND LOCAL GOVERNMENTS, SELECTED YEARS, 1902–1952

			LOCAL					
YEAR [a]	TOTAL	STATE	*Total*	*County*	*City* [b]	*Township* [c]	*School District* [d]	*Special District*
			Amount (millions of dollars)					
1902	$ 2,194	$ 270	$ 1,924	$ 205	$ 1,612	$ 57	$ 46	$ 5
1913	4,498	423	4,075	393	3,447	80	119	36
1922	10,256	1,163	9,093	1,387	5,810	130	1,127	639
1932	19,587	2,907	16,680	2,775	9,909	433	2,170	1,393
1940	20,246	3,526	16,720	2,156	9,899	290	1,813	2,562
1942	19,690	3,211	16,479	1,846	9,806	273	1,701	2,853
1944	17,471	2,768	14,703	1,694	8,624	e	1,465	2,718
1945	16,589	2,425	14,164	1,545	8,411	e	1,363	2,667
1946	15,922	2,358	13,564	1,417	8,101	e	1,283	2,597
1947	16,825	2,978	13,847	1,481	8,097	e	1,355	2,736
1948	18,702	3,722	14,980	1,408	8,859	276	1,560	2,877
1949	20,875	4,024	16,851	1,603	9,496	310	2,147	3,295
1950	24,191	5,361	18,830	1,707	10,908	339	2,710	3,166
1951	27,040	6,373	20,667	1,875	11,721	411	3,257	3,403
1952	30,100	6,874	23,236	2,018	12,659	619	3,806	4,125

Percentage of Total Debt Outstanding

87.7	9.3	73.5	2.6	2.1	.2
[illegible]	8.7	76.6	1.8	2.6	.8
	13.5	56.6	1.3	11.0	6.2
	[illegible]	50.6	2.2	11.1	7.1
		48.9	1.4	9.0	12.7
			1.4	8.6	14.5
			e	8.4	15.6
			e	8.2	16.1
		.9	e	8.1	16.3
		8.1	e	8.1	16.3
		47.4	1.5	8.3	15.4
		45.5	1.5	10.3	15.8
		45.1	1.4	11.2	13.1
		43.3	1.5	12.0	12.6
		42.1	2.1	12.6	13.7

re not shown separately. Detailed estimates are not com-
ble with data for previous years.

rce: Bureau of the Census, *Historical Review of State and* *cal Government Finances*, 1948, p. 18; *Summary of Govern-* *ent Finances in 1952*, 1953, p. 32. Except for 1952, state data do not reflect recent revisions made by the Bureau of the Census for even years since 1942; the major change was a reduction in the 1952 amount from $7,040 million to $6,874 million. See *Revised Summary of State Government Finances, 1942–1950*, 1953.

NATIONAL BUREAU OF ECONOMIC RESEARCH, Inc.
261 Madison Avenue
New York 16, N. Y.

TO SUBSCRIBERS:

The Ownership of Tax-Exempt Securities, 1913–1953, by George E. Lent, is being sent to you on your subscription to the National Bureau of Economic Research.

It is issued as number 47 in the National Bureau's *Occasional Paper* series.

WILLIAM J. CARSON
Executive Director

gations amounted to about 25 per cent of total state debt compared with about 35 per cent for highways.[9]

Before World War I about three-fourths of all state and local securities were obligations of municipalities. With the development of specialized political units, the importance of municipal debt fell to about half of the total in 1932 and remained at that proportion until the end of World War II. Although municipal debt has greatly increased since the end of the war, its share of the total has steadily declined to about 42 per cent of the total in 1952. Municipal borrowing has been occasioned principally by the financing of various public-service enterprises, such as water-supply systems, transit systems, and power and gas facilities. Between 1919 and 1952 debt incurred for such purposes has increased from one-third to about 40 per cent of the total. Borrowing for streets and roads and for school buildings has also been of considerable importance.[10]

County debt attained its largest proportion—14.2 per cent—in 1932; its share of the total has since dropped to about one-half of its former importance. Borrowing of townships has never been significant, ranging between 1.5 and 2.0 per cent.

Obligations of specialized governmental units, such as school districts and special districts, have experienced the most significant relative increase in debt since 1913. Between 1913 and 1922 obligations of school districts rose from 2.6 per cent to about 11 per cent of total state and local securities. After 1932 their relative importance declined to around 8 per cent of the total, but since the war they have increased to nearly 13 per cent.

The formation of special districts as a means of financing public improvements was one of the most notable developments of this period.[11] Virtually unknown in 1902, with only $5 million of loans

[9] Bureau of the Census, *Compendium of State Government Finances in 1952,* p. 42.
[10] Bureau of the Census, *Financial Statistics of Cities, 1919; Compendium of City Government Finances in 1952,* pp. 79, 118.
[11] Special districts are autonomous political units chartered by the states for the administration of some special public service. They consist principally of irrigation and drainage districts, water supply, port, bridge, and road districts, public-housing authorities, and a great variety of other types. For relevant data see Bureau of the Census, *Special District Governments in the United States,* Jan. 6, 1954.

outstanding, the debt of these districts expanded rapidly after World War I to over $600 million in 1922. The next phase of their expansion was between 1932 and 1942, when their share of total debt more than doubled to around 16 per cent, in contrast with an absolute decline in the debt of all other categories of local government. By 1952 their importance declined to 13 per cent.

The relative importance of the major functional purposes for which long-term debt of special districts was outstanding in 1952 is indicated by the following classifications:

	Amount (mill. $)	*Percentage Distribution*
Utilities	$1,227	33.0
Water supply	458	12.3
Other utilities	769	20.7
Housing	1,130	30.4
Natural resources	497	13.4
Sanitation	313	8.4
All other	551	14.8
Total	$3,717	100.0

Source: Bureau of the Census, *Special District Governments in the United States,* 1954, p. 8.

Considerable impetus was given to the development of special governmental districts by the federally sponsored public-works program initiated in 1932.[12] The "self-liquidating" nature of the sponsored projects lent itself readily to the formation of special governmental units, such as sewer and water districts, to carry out the financing. Bonds secured by the revenues of these public authorities could be used to avoid constitutional and other legal

12 The Emergency Relief and Construction Act of 1932 first promoted the construction of nonfederal "self-liquidating" projects through loans of the Reconstruction Finance Corporation. With the enactment of the National Industrial Recovery Act of June 1933, the Reconstruction Finance Corporation was largely superseded in this function by the Public Works Administration. Both of these agencies were authorized to make loans directly to communities and other public bodies, thus marking a radical departure in federal intergovernmental relations, which hitherto had been conducted on the state level.

debt limitations on further general "faith and credit" debt which severely circumscribed local borrowing during this period.[13]

This period also marked the rise of the public authority as an instrument of public financing.[14] Further stimulus was given to the formation of public authorities by the Public Housing Act of 1937 and the Housing Act of 1949. In June 1949 tax-free obligations of public-housing authorities approved under the 1937 act amounted to about $.6 billion. Obligations authorized under the 1949 act increased the total to $1.7 billion in June 1952 and to $2.5 billion by June 1953. More recently, extensive financing of toll highways and bridges has also been undertaken by public authorities.

Growth of Enterprise Debt and Nonguaranteed Obligations. One of the most significant developments since World War I has been the expansion of public-service enterprises by state and local governments. As distinguished from "general" debt undertaken for the provision of services identified with the traditional functions of state and local governments—such as roads, education, sanitation, and welfare—"enterprise" debt is incurred for facilities that supply essential services which are sold by the government for a fee or a price. While many of these services have traditionally been supplied by local governments in lieu of private industry, a marked growth in such governmental services occurred in the last two decades.

Between 1921 and 1931 there was relatively little increase in the proportion of enterprise debt, which accounted for about one-fifth of gross state and local borrowing. During the next decade, however, enterprise debt increased to about one-third of the total. Its relative importance remained about the same in 1951.

A similar expansion has taken place in the use of securities not backed by the full faith and credit of the government, that is, non-

[13] See J. K. Williams, *Grants-in-Aid under the Public Works Administration* (Columbia University Press, 1939), p. 234.

[14] The prototype of this form of organization was the Port of New York Authority, which was established in 1921 as a means of coordinating the common interests of New York State and New Jersey in harbor and other transportation facilities. Such authorities are endowed in general with the attributes of a governmental unit but do not enjoy the power to tax.

guaranteed obligations. Changes in census classification, however, somewhat impair comparisons over time. The proportion of total revenue bonds, special assessment obligations, and quasi-revenue bonds increased slowly from around 10 per cent of the long-term debt in 1913 to around 14 per cent in 1942. By 1952, however, "nonguaranteed" obligations increased to 18.5 per cent of total long-term state and local debt. This recent development may be largely accounted for by the postwar expansion of toll roads, bridges, etc., the obligations of which are payable from pledged revenues.[15]

Attempts to Repeal Exemption. Since 1913 state and local governments have successfully withstood attempts to eliminate the exemption of their securities from federal income taxation. The first real effort was made during World War I, when the existence of such tax-free obligations was believed to threaten the market for federal bonds. Supported by the Treasury Department, the House of Representatives—in the revenue bill of 1918—overwhelmingly approved taxation of outstanding issues,[16] but this move failed in the Senate principally because of doubts over its constitutionality.

Following the end of the war, strong public support developed for the elimination of tax exemption. Its inequities under the highly graduated income tax rates were apparent. It was also widely believed that tax exemption diverted capital from other investments, particularly mortgage loans. The Treasury was also concerned over its effects on federal revenues and the accumulation of public debt.[17]

Extensive public hearings by the Committee on Ways and Means

15 Data were derived from Bureau of the Census, *Wealth, Debt and Taxation,* 1915; *Government Debt in the United States: 1942; Summary of Governmental Finances in 1952.* Nonguaranteed debt includes obligations payable solely from pledged specific sources, such as earnings of plants, specific nonproperty taxes, or special assessments, and which do not constitute obligations on any other resources of government if the pledged sources are insufficient. Revenue bonds are payable exclusively from earnings or charges of revenue-producing enterprises or services.

16 *Congressional Record,* 65th Cong., 2d sess., 1918, pp. 10373, 10409.

17 *Annual Report of the Secretary of the Treasury, 1919,* p. 24; *1920,* p. 37; *1921,* pp. 354, 379–380.

culminated in the Green resolution to amend the Constitution so as to authorize reciprocal taxation of state and federal securities.[18] This the House approved by the necessary two-thirds vote, on January 23, 1923, but the Senate rejected it. When the same amendment was introduced the following year, the House failed to approve it. Opposition developed principally because federal taxation would raise the cost of state and local borrowing without compensatory advantages from taxing federal bonds. The resolution was also opposed as a conspiracy of the banking interests to repeal the tax-exemption privilege of farm loan bonds and thereby raise interest costs to farmers.[19] But one of the most decisive factors in the changing sentiment was the postwar reduction in personal income tax rates.[20] The Green resolution of 1923–1924 thus marked the high tide of the attempts to eliminate tax-exempt securities by constitutional amendment during the 1920's.

Sentiment for taxing state and local bond interest revived with the return of high surtax rates after 1932. Between 1932 and 1937 no less than eighty resolutions were introduced to accomplish this purpose by constitutional amendment, only one of which reached a vote.[21]

In April 1938 President Roosevelt called upon Congress to repeal tax exemption by legislative action instead of relying on the "cumbersome and uncertain remedy" of a constitutional amendment.[22] This move was encouraged by a decision which sanctioned

18 *Hearings on Tax Exempt Securities,* H.J. Res. 102, 211, 231, 232, Jan. 16–19, Mar. 7, 1922.

19 *Congressional Record,* 68th Cong., 1st sess., pp. 2008, 2037.

20 By 1926, surtax rates were limited to 20 per cent compared with a maximum of 65 per cent in 1921. It is also suggested that publication of Hardy's study, *Tax-Exempt Securities and the Surtax,* in 1926, dispelled the idea that government revenues were lost by tax exemption. See Lucile Derrick, *Exemption of Security Interest from Income Taxes in the United States* (University of Chicago Press, 1946), p. 22. These estimates rested on rather tenuous assumptions and were much criticized. C. Heer, "Review of Hardy's Tax-Exempt Securities and the Surtax," *Political Science Quarterly,* June 1926, pp. 271–280.

21 See Derrick, *op. cit.,* Appendix, for a compilation of these resolutions.

22 Previously, in 1933, the Senate approved an amendment to the National Industrial Recovery Act which would tax all outstanding as well as future issues of federal, state, and local issues, but it was dropped by the Conference Committee. *Congressional Record,* 73d Cong., 1st sess., 1933, 5420–5421, 5857.

federal taxation of state and local salaries, in the Port of New York Authority case.[23]

In hearings before a special Senate committee in 1938, the Treasury opposed exemption on grounds of its inequitable tax effects, alleged diversion of risk capital from business enterprise, and net revenue loss to government (that is, the lower interest cost to government was claimed to be less than the tax savings of bondholders).[24] The states rested their case against repeal principally on grounds of its discriminatory fiscal effects in raising the cost of state and local government without compensatory benefits.[25] The proposed legislation was also attacked on constitutional grounds. Debate along similar lines was continued before the Committee on Ways and Means.[26]

Following the majority recommendation of the special Senate committee, a bill was introduced September 14, 1940, which provided for reciprocal taxation of interest on future issues of federal, state, and local securities, with the exception of refunding issues whose maturity was not extended beyond the original maturity date. This bill, the Public Bond Tax Act of 1940, was defeated in the Senate September 19, by a vote of 30 to 44.

In 1941 the Bureau of Internal Revenue instituted a test case against bondholders of the Port of New York Authority "intended ultimately to prove in the courts that the federal government has the right under the Constitution to tax income from state and municipal securities." [27] However, the courts upheld the exemption of Authority bonds under the Internal Revenue Code, and the Treasury was blocked in the next step it intended—that of challenging their constitutional immunity.[28]

[23] *Helvering v. Gerhardt,* 304 U.S. 405 (May 23, 1938), rehearing denied, 59 Sup. Ct. 57.

[24] Special Committee on Taxation of Government Securities and Salaries, *Hearings,* S. Res. 303, 75th Cong., 3d sess., 1938, pp. 5–10.

[25] *Ibid.,* pp. 88, 93–186.

[26] *Hearings on Proposed Legislation Relating to Tax Exempt Securities,* 76th Cong., 1st sess., 1939.

[27] *Annual Report of the Secretary of the Treasury, 1941,* p. 47.

[28] *Shamberg v. Commissioner,* 3 T.C. 131 (Jan. 28, 1944). The Court of Appeals affirmed the Tax Court decision against the government and denied review, 144 F. 2d 998 (Aug. 24, 1944). The Supreme Court denied certiorari, Jan. 2, 1945.

With the outbreak of the war the Treasury took the unusual step of recommending that all outstanding as well as future issues of state and local securities be made fully subject to tax.[29] The Committee on Ways and Means rejected this proposal, but the Senate Finance Committee amended the revenue bill so as to tax future issues. A floor amendment, however, defeated this provision by a vote of 52 to 34.

The tax-exemption issue was not revived until early 1949, when a question arose over the taxation of Public Housing Authority bonds authorized by the Housing Act of 1949. These bonds were virtually guaranteed by the federal government through the pledge of a federal contract providing for annual subsidy payments to meet principal and interest charges.[30] Strong objections to their exemption from federal taxes were raised by the Housing Administrator and by the Treasury. However, since this matter was believed to be the prerogative of the Finance Committee, the Senate Committee on Banking and Currency, which wrote the housing bill, excluded any provision which would subject interest on these securities to federal income tax.[31]

In 1951 the Treasury again recommended removal of state and local tax exemption. This move was effectively blocked by a well-organized campaign of the states and municipalities and never reached a vote.[32]

29 House Committee on Ways and Means, *Hearings on the Revenue Act of 1942*, 77th Cong., 2d sess., Mar. 3, 1942, p. 2.

30 The Attorney General of the United States removed possible doubts over the federal guarantee of these obligations in a statement dated May 15, 1953: "In summary, I am of the view that; . . . a contract to pay annual contributions entered into by the PHA in conformance with the provisions of the Act is valid and binding upon the United States, and that the faith of the United States has been solemnly pledged to the payment of such contributions in the same terms its faith has been pledged to the payment of its interest-bearing obligations."

31 "General Housing Legislation," *Hearings before subcommittee of the Senate Committee on Banking and Currency*, 81st Cong., 1st sess., Feb. 3–21, 1949, p. 59.

32 House Committee on Ways and Means, *Hearings on Revenue Revision of 1951*, 82d Cong., 1st sess., 1951, Part 2, pp. 903–1159.

Tax-Exempt Securities Issued under the Federal Farm Loan System

Organization of the Farm Loan System, 1913–1921. The Federal Farm Loan Act, approved July 17, 1913, marked a departure in the use of the tax-exemption device to further the sale of bonds which were in no formal sense obligations of the United States government. This act authorized the establishment of twelve regional farm loan banks under the general administration of the Farm Loan Board. Its purpose was to provide credit for financing long-term mortgage loans to farmers at a minimum and uniform cost throughout the country, through the agency of both cooperative farm loan associations and joint-stock land banks chartered by the federal government. Unlike the farm loan associations, the joint-stock land banks were privately financed business corporations operated for a profit to their stockholders.

As instrumentalities of the federal government, the federal land banks and loan associations were exempted from state and local taxes with respect to their capital and surplus, mortgages executed, and bonds issued for their financing. More important, the interest on farm loan bonds issued by both the federal land banks and joint-stock land banks was completely exempted from federal income taxes.

Several reasons were offered for this exemption policy. Perhaps foremost was the objective of financing farm mortgages at the lowest possible cost to the farmer.[33] The act provided that interest charged farmers was not to exceed the cost of borrowing by a margin of one percentage point. Since the farm loan system was established as an alternative to direct federal financing of farm mortgages, it was proposed to accord farm loan bonds the exemption privileges then enjoyed by federal bonds.[34] Exemption from state taxes was urged to avoid possible discriminatory taxation by the states.

Because of the delays in organizing the system, no substantial

[33] See *Report of Joint Committee on Rural Credit,* H. Doc. 494, *Congressional Record,* 64th Cong., 1st sess., 1916, p. 6697.
[34] *Ibid.*

financing of the federal land banks was undertaken by the Farm Loan Board until November 1917. At this time a bond issue of $30 million was successfully sold to the public;[35] by June 30, 1918, bonds in the amount of $106 million had been issued. However, because of the extraordinary credit demands of the war and the uncertain constitutionality of the Farm Loan Act,[36] the Treasury was authorized to supply the necessary funds. Total bonds of the federal land banks outstanding were increased to $244 million by 1919 and to $374 million by June 30, 1921.

The joint-stock land banks got off to an even slower start. By November 30, 1918, only nine banks were chartered, with outstanding tax-exempt bonds of $7.7 million.[37] By June 30, 1920, however, thirty banks were chartered, and tax-exempt bonds in the amount of $75 million were outstanding. Further expansion was curbed by the litigation over the Farm Loan Act.

Development of the Farm Loan System, 1921–1929. The Agricultural Credit Act of 1923 augmented the federal farm loan system by the establishment of twelve regional intermediate credit banks. Each bank was capitalized at $5 million, subscribed by the Treasury, and was authorized to issue tax-exempt short-term collateral debentures not to exceed ten times its capital and surplus. Debentures were initially issued August 1, 1923, with six-month maturities.[38]

Between June 1921 and June 1929 wholly tax-exempt bonds issued under the authority of the Farm Loan Act (as amended) increased from $450 million to $1,867 million (Chart 4). Obligations of the federal land banks accounted for about 63 per cent of the total; joint-stock land-bank bonds represented about 35 per cent;

35 Federal Farm Loan Board, *First Annual Report,* Jan. 3, 1918, p. 19.

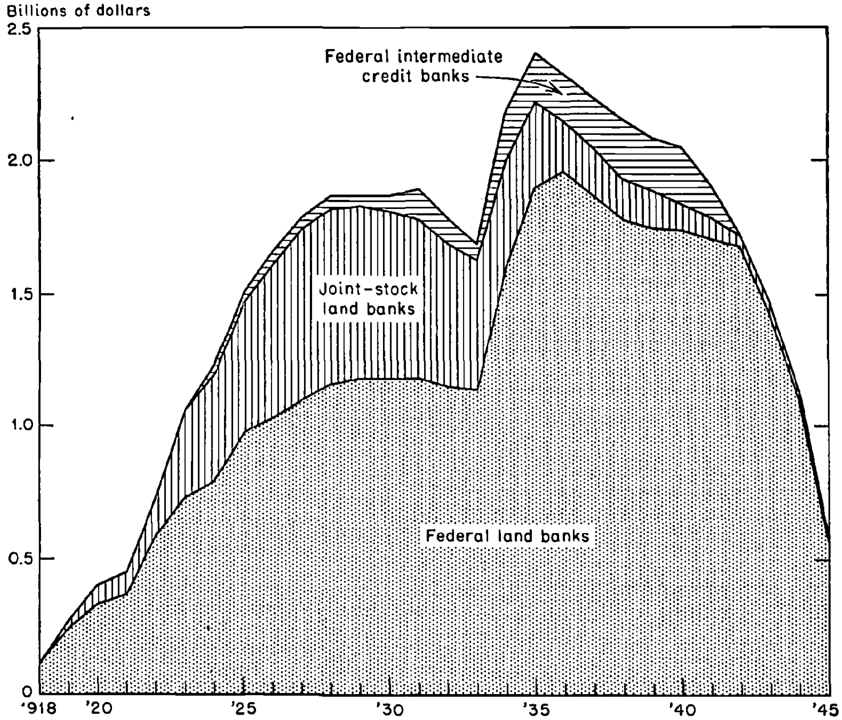
36 A long-threatened suit to contest the constitutionality of the Farm Loan Act was instituted in August 1919. Upon dismissal of the bill the case was carried to the Supreme Court for hearing on Jan. 5, 1920. It was not until Feb. 28, 1921, that the Supreme Court affirmed the constitutionality of the act, and the federal farm loan system was firmly established. *Smith v. Kansas City Title and Trust Company,* 255 U.S. 180 (1921).

37 Federal Farm Loan Board, *Second Annual Report,* 1918, p. 29; *Third Annual Report,* 1919, p. 3.

38 *Annual Report of the Secretary of the Treasury, 1923,* p. 44.

CHART 4

FEDERAL FARM LOAN WHOLLY TAX-EXEMPT SECURITIES OUTSTANDING, 1918–1945



Source: Table D-1.

and debentures of the intermediate credit banks amounted to only 2 per cent.

The Final Stages, 1929–1946. Federal land-bank borrowing was stabilized at $1,180 million between 1929 and 1931. Because of declining bond prices and rising interest rates, the banks were faced with a choice of long-term financing under a situation which appeared to be temporary or of meeting their loan requirements through mortgage repayments and temporary financing.[39] The

[39] Between January 1928 and September 1929 the yield on land-bank bonds increased from 3.95 per cent to 4.91 per cent, and by September 1931 reached 5.96 per cent. H. C. Larsen, "Government Participation in Financing of Federal Land Bank Operations," *Agricultural Financing Review,* Dept. of Agriculture, May 1941, p. 15.

latter course was chosen with the cooperation of the Federal Reserve banks, which purchased short-term issues at moderate interest rates in 1929.

Proposals made near the close of 1929 for the purchase of federal land-bank bonds by the Treasury were opposed by the Secretary. No public offerings were made in 1931, and needs were supplied on a temporary basis by sale of short-term issues to the Federal Reserve Bank of New York.

During the entire period 1931–1933 interest yields on land-bank bonds remained above 5 per cent and precluded public sale of bonds which would enable mortgage loans to be made at the statutory maximum of 6 per cent or less.[40] In 1934 the total amount of federal land-bank securities increased for the first time since 1929, from $1,142 million to $1,602 million. The volume reached its peak of $1,964 million in June 1936.

With the removal of federal tax exemption by the Public Debt Act of 1941, the supply of these wholly tax-exempt securities declined rapidly because of their maturity of less than five years, and they disappeared entirely by 1946.

Tax-exempt debentures of the intermediate credit banks increased from $35 million in June 1929 to over $200 million between 1938 and 1940. By the end of 1941 these wholly tax-exempt obligations were retired with the expiration of their tax-exempt privileges by the Public Debt Act of 1941.

With the onset of the depression in 1930, joint-stock land banks encountered increasing delinquencies and foreclosures which threatened their solvency and made new financing difficult.[41] Partly through bank purchases of their own bonds at substantial discounts, their outstanding tax-exempt bonds continued to decline from the peak of $657 million in June 1928.[42] Congress was unwilling to come to their rescue as it had in the case of farm loan

[40] *Ibid.*, p. 16. In January 1932, Congress authorized additional stock subscriptions by the government of $125 million.
[41] Three joint-stock banks were placed in receivership as early as 1927 and their liquidation continued until February 1933. Federal Farm Loan Board, *Annual Report,* 1932, p. 28.
[42] Federal Farm Loan Board, *Annual Report,* 1931, p. 42.

banks, but several banks were assisted by loans from the Recon struction Finance Corporation.

Finally, in May 1933, Congress terminated the existence of joint-stock land banks as lending institutions. The Emergency Farm Mortgage Act of 1933 prohibited these banks from issuing any tax-exempt bonds, and it further prohibited them from making any mortgage loans other than those necessary to the refinancing of existing loans or bond issues. Thereafter, the banks were operated only for the purpose of orderly liquidation of their assets and retirement of bonds. It was not until 1945 that these securities disappeared and ceased to be a factor in the tax-exempt investment market.

Federal Tax-Exempt Securities

Pre–World War I Debt, 1913. The federal government has followed no consistent policy with respect to the taxation of interest on its own issues. Until 1864 interest on United States government securities was partially exempt from the Civil War income tax, being assessed at a rate of 1½ per cent compared with rates on other income ranging from 3 to 5 per cent. At that time interest was made fully taxable at 5 to 10 per cent [43] until 1870, when complete exemption was provided future issues despite the scheduled expiration of the income tax in 1872.[44] The income tax of 1894 provided for the taxation of future issues at the uniform rate of 2 per cent, but that law was invalidated in its entirety by the Supreme Court.[45]

In 1913 the gross interest-bearing debt of the federal govern-

[43] This change was opposed as a violation of faith with those who bought the securities subject to the preferential rate; continuation of the exemption policy was opposed as an undue advantage to investors, who not only received interest payments in gold and silver but also escaped state and local taxes. An amendment to remove partial exemption was at first rejected by a thin house but was then carried by a close vote. *Congressional Globe,* 38th Cong., 1st sess., 1864, pp. 1854, 1875.

[44] Secretary of the Treasury Boutwell recommended this reversal in policy. The issue of 1871 (5's of 1881) was the first to state on the face of the bond: "The principal and interest are exempt from the payment of all taxes or duties of the United States, as well as taxation in any form by or under state, municipal, or local authority."

[45] *Pollock v. Farmers' Loan and Trust Company,* 157 U.S. 429 (1895), 158 U.S. 601 (1896).

ment stood at slightly less than $1 billion. It consisted of the following principal issues, of which the consols of 1930 were the most important:

Consols of 1930	$646,250,150
Panama Canal loan	134,632,980
Loan of 1925	118,489,900
Loan of 1908–1918	63,945,460
Miscellaneous	2,388,120
Total	$965,706,610

All these bonds were exempt from all federal and state taxes under the terms of their issue. Since they also carried the circulation privilege as security for national bank notes, they bore a low rate of interest of only 2 per cent. The federal interest-bearing debt remained substantially unchanged until the outbreak of war with Germany, April 6, 1917.

World War I Financing. With the outbreak of war, measures were quickly taken to finance the large military requirements. The First Liberty Loan Act, approved April 24, 1917, authorized the Treasury to borrow $5 million by bonds and short-term certificates of indebtedness, which were made exempt, both principal and interest, "from all taxation, except estate and inheritance taxes, imposed by authority of the United States, or its possessions, or by any state or local taxing authority." [46] There appears to have been very little concern with tax exemption at this time. The problem of the day was how to market successfully the unprecedentedly large issue in view of the prospective increase in tax burdens necessary to finance the war.

The first Liberty loan thirty-year bonds were offered on May 14 in an amount of $2 billion. They carried an interest rate of 3½ per cent, as fixed by law, and were made both redeemable upon three months' notice and convertible into future Liberty loan issues. The amount of bonds outstanding on June 30, 1917, represented by actual receipt of payment, was $1,466 million. In addition there were outstanding short-term tax-exempt certificates in the amount of $286 million.

[46] Public Law 3, 65th Cong., 1st sess., 1917.

When greatly increased borrowing became necessary by September 1917, the Treasury opposed continuation of the existing tax-exemption policy. Because of equity considerations and marketing conditions, it concluded that future bonds of the United States should be made exempt only from normal income taxes and stamp taxes.[47] It was believed that the success of the first Liberty loan did not depend on the exemption feature and that the lower interest rate made possible thereby held little attraction for the lower-income groups. Although removal of the surtax exemption would entail an increase in the interest rate to 4 per cent, this higher rate was thought essential to the widest public distribution of the public debt.[48] Exemption from normal tax, however, was believed necessary to keep the interest rate from rising above 4 per cent. After considerable debate Congress adopted a partial tax-exemption formula which established the basic pattern for future Liberty loans. This provided for unlimited exemption from normal taxes and limitation of surtax exemption to interest on a specified principal amount of bonds.

The second Liberty loan of $3 billion, with interest at 4 per cent, was offered to the public on October 1, 1917. By May 15, 1918, 28.6 per cent of the wholly tax-exempt first Liberty bonds outstanding were exchanged for the new partially tax-exempt securities. This conversion left outstanding $1,421 million of wholly tax-free Liberty bonds, in addition to almost $1 billion of prewar loans.

The Third Liberty Loan Act, approved April 4, 1918, simply retained the exemption provisions of the Second Liberty Loan Act. With issuance of the third Liberty loan, May 9, 1918, the outstanding volume of partially tax-exempt securities on June 30, 1918, reached $9.6 billion. Wholly tax-exempt securities then amounted to $2.3 billion.

In July 1918 the Congress passed the Fourth Liberty Bond Act, which increased Liberty bond authorizations from $12 billion to $20 billion. The Treasury was able to meet current needs by the

[47] House Committee on Ways and Means, *Hearings on Second Emergency Bond Issue,* H.R. 5901, 65th Cong., 1st sess., Aug. 28, 1917, p. 20.
[48] *Annual Report of the Secretary of the Treasury, 1917,* p. 9.

use of short-term certificates, however, and did not plan a new bond campaign until fall.

By the end of summer the Treasury became concerned over the effects of the pending tax bill on the bond market. Despite its previous position against surtax exemption, it now favored limited surtax exemption as the most effective means of avoiding an increase in interest rates. It therefore recommended that a portion of the income from the new bonds be made exempt from surtaxes during the period of the war and a brief interval thereafter, and that retroactive exemption be given outstanding bonds in a specified ratio to holdings of the fourth Liberty loan.[49] These recommendations were incorporated in the supplement to the Second Liberty Loan Act, approved September 24, 1918.[50] The fourth Liberty loan of $6 billion, offered September 28, was oversubscribed at $6,964 million.

After the end of the war it became necessary to make one final appeal to the public for the purchase of war bonds—the Victory loan. In view of the size of the loan originally contemplated, $7 billion, the Treasury sought more discretionary power in its issuance than was available in the Fourth Liberty Loan Act. By this time the patriotic appeals employed so effectively during the heat of the conflict could no longer be relied upon in the same measure for large popular subscriptions. The prices of outstanding issues were slumping, and unusual measures were indicated if the Treasury was to avoid any appreciable increase in interest rates and the cost of financing the war. The Treasury therefore requested full authority to determine the tax exemptions of the forthcoming issue and to enlarge the exemption rights of existing bondholders who purchased new bonds.

49 *Annual Report of the Secretary of the Treasury, 1918,* pp. 15–16.

50 This amendment provided for surtax exemption of interest on $30,000 each of the fourth Liberty bonds, and the first Liberty bonds converted, until two years after the end of the war. In addition, holders of these bonds on the income tax date were given similar exemptions on one and one-half times their principal amount of previous issues held on the tax date. This exemption was limited to interest received between Jan. 1, 1918, and two years after the official termination of the war. These bonds already enjoyed an aggregate exemption of $5,000 under the Second Liberty Loan Act.

The Victory Liberty Loan Act was approved by Congress on March 3, 1919, after considerable debate over the unusual delegation of authority to the Secretary of the Treasury. Congress did not grant the full authority requested, but gave the Secretary power to issue one- to five-year notes on such terms and conditions as he deemed necessary under the circumstances. These notes were given four alternative tax-exemption privileges, including full surtax exemption, to be used at the discretion of the Secretary. The law also provided additional surtax exemptions for the 4 per cent and 4¼ per cent Liberty bonds in order to stabilize their market.[51]

The Treasury's dilemma was neatly resolved by the issuance of two classes of notes dated May 20: one fully tax-exempt, with interest at 3¾ per cent, and the other partially tax-exempt, with interest at 4¾ per cent. Each was made convertible into the other during a life of both issues, which for practical purposes was three years.

The Victory loan of $4.5 billion was announced on April 14, 1919. Subscriptions to the 4¾ per cent partially tax-exempt notes greatly exceeded those to the 3¾ per cent wholly tax-exempt notes. On June 30, 1919, fully paid subscriptions to the wholly tax-exempt issue amounted to $534.4 million and by June 30, 1920, to $818.4 million—only 19 per cent of total fully paid subscriptions to the fifth Liberty loan. These notes were subsequently reduced by exchanges for refunding issues, and on June 15, 1922, the remaining amount of about $250 million was called for redemption.

The retroactive surtax-exemption feature introduced by the fourth Liberty loan was greatly enlarged with the issuance of the Victory loan. The maximum principal amount of an individual bondholding for which exemption from surtaxes and war-profits taxes could be obtained was $160,000, with maximum bond interest of $6,800.[52]

51 Public Law 328, 65th Cong., 3d sess., 1919.

52 This maximum could be achieved by a judicious distribution of Liberty bonds and notes for which an aggregate amount of exemption was given up to $100,000 principal amount, in addition to holdings of $30,000 first second 4¼'s and $30,000 of fourth 4¼'s for which separate exemptions were given. Certain exemptions were, of course, conditional upon original subscription to, and continuous holdings of,

(Continued on page 36)

Debt Retirement, 1919–1929. The decade from June 30, 1919, to June 30, 1929, saw the federal interest-bearing debt reduced $8.8 billion, from $25.4 billion to $16.6 billion, or about 37 per cent of the amount outstanding in June 1919.[53] Redemption of partially tax-exempt obligations accounted for virtually all of this reduction.

With the retirement of $800 million 3¾ per cent Victory notes by June 15, 1922, federal wholly tax-exempt securities were scaled down from a peak of $3.1 billion in June 1920 to $2.3 billion by June 1922. Redemption of the 4 per cent loan of 1925 at maturity further reduced the amount of tax-free debt to $2.2 billion, where it remained for the rest of this period. Throughout the 1920's the amount of first Liberty loan bonds outstanding stood unchanged at $1.4 billion. After 1922 the balance of the wholly tax-exempt debt consisted of various prewar issues.

The greater part of the limited surtax-exemption privilege expired by July 2, 1923, two years from the official expiration date of the war. Until July 2, 1926, each taxpayer was limited to surtax exemption on $55,000 principal amount of bonds. After that date, individual holdings of only $5,000 of securities were fully tax-exempt for their remaining life.

Partially tax-exempt issues outstanding were gradually reduced as the government retired its total debt. By June 30, 1929, the total amount outstanding declined to $13.9 billion, compared with a maximum of $22.6 billion on June 30, 1919. On June 30, 1929, partially tax-exempt bonds accounted for 87 per cent of the gross interest-bearing federal debt, the balance of 13 per cent being wholly tax-exempt.

The Revival of Tax-Free Securities, 1929–1940. In 1928 the Treasury recommended that the Second Liberty Loan Act be amended so as to permit issuance of federal tax-free securities.

---

fourth Liberty bonds and Victory 4¾ per cent notes in the stipulated proportions. It should be noted, however, that a negligible amount of first second 4¼'s outstanding severely circumscribed the possibilities of maximizing such limited exemptions. Since there were only about $3.5 million of this issue outstanding, less than 120 persons could realize the maximum surtax advantages.

53 The peak of the World War I debt was somewhat higher than $25.2 billion. Excess cash balances were initially used to offset excess borrowing in 1919.

Secretary Mellon justified this reversal in policy by the failure of the movement during the 1920's to abolish state and local tax exemption.[54] He also argued that surtax exemption would remedy the advantage then given to corporations by their normal tax exemption and make federal securities more attractive to individuals. Largely because of the higher normal tax rate levied on corporations at the time, partially tax-exempt issues were gravitating into the hands of commercial banks.

Congress amended the Second Liberty Bond Act in June 1929 so as to provide that all certificates of indebtedness and Treasury bills be made exempt from surtaxes as well as normal taxes, except for taxes on inheritances and estates.[55] The market competition between state and local securities and governments was thus equalized with respect to short-term securities. Congress was unwilling, however, to extend this equalization to longer-term Treasury bonds.

The new tax-exempt feature was first used on September 16, 1929, with an offering of nine-month certificates at 4⅞ per cent. Tax-exempt Treasury bills were first offered December 17, 1929, on a ninety-day basis, in the amount of $100 million.[56]

In 1930 the Treasury renewed its recommendation to extend surtax exemption to Treasury bonds.[57] This move was in anticipation of the early call date on a huge portion of World War bonds, including the $1.4 billion wholly tax-exempt first Liberty bonds. However, Congress was still unwilling to take this step.

The fiscal year 1931 marked the beginning of a new era in Treasury finances, when the business contraction which set in during the

[54] Secretary Mellon contended that "there is no reason why the Treasury Department in marketing securities should be at a disadvantage as compared with the states and their subdivisions, or why there should be discrimination against individual investors who desire to acquire United States Government securities." *Annual Report of the Secretary of the Treasury, 1928,* pp. 89, 90.

[55] Public Law 11, H.R. 1648, 71st Cong., 1st sess., June 17, 1929. This amendment introduced the Treasury bill, a short-term instrument sold competitively on a discount basis, which was believed to meet the requirements of greater flexibility in Treasury interim financing.

[56] An act approved June 19, 1930, made Treasury bills, issued on a discount basis, further exempt from the tax on capital gains.

[57] *Annual Report of the Secretary of the Treasury, 1930,* p. 39.

last quarter of 1929 turned the annual budgetary surplus of the past eleven years into a deficit of almost a billion dollars. In order to achieve a balanced budget by 1933, the Treasury urged Congress to reduce expenditures and to increase taxes.[58]

The imminence of higher tax rates did not deter the Treasury from pursuing its tax-exemption policy. In December 1931 the Secretary offered the first fully tax-exempt notes since the issue of 1919. These 3¼ per cent, one-year securities initiated a series of notes which eventually formed the principal basis of the Treasury's tax-free financing program. By June 1933 the $9.8 billion of wholly tax-exempt federal issues outstanding approached the volume of partially exempt issues of $12 billion. At this time, federal wholly tax-exempt securities accounted for 31.5 per cent of the gross amount outstanding by all governments.

The new administration which took office in March 1933 at first made no change in tax-exemption policy. While Secretary Morgenthau supported the adoption of a constitutional amendment which would enable future government issues to be taxed on a reciprocal basis, he was unwilling as yet to surrender the tax-exemption feature of federal bonds.[59]

Between 1933 and 1936 important changes took place in the amount and composition of the tax-exempt debt. June 1936 marked the peak of federal wholly tax-exempt securities outstanding, with an amount of $14.9 billion. Consisting principally of United States notes, this completely tax-free debt constituted about 40 per cent of all public issues of the federal government, as well as about 40 per cent of the gross amount of all outstanding wholly tax-exempt issues. The volume of partially tax-exempt Treasury bonds, however, expanded at a faster rate and by June 30, 1936, stood at $22.2 billion compared with $12 billion on June 30, 1933.

During the year 1935 the Treasury undertook extensive refunding of several long-standing issues. In June the first Liberty loan

[58] *Annual Report of the Secretary of the Treasury, 1931,* p. 28.

[59] Letters to Chairman of the Senate Committee on Finance, Mar. 6, 1934, and to Chairman of Committee on the Judiciary, Mar. 8, 1934. Reprinted in House Committee on Ways and Means, *Hearings on Proposed Legislation Relating to Tax Exempt Securities,* 76th Cong., 1st sess., 1939, p. 462.

bonds were called, thereby retiring the largest single issue of wholly tax-exempt bonds. Closely following, on July 1, was the redemption of the prewar issues of 2 per cent consols of 1930 and Panama Canal loans of 1916–1936 and 1918–1938, leaving a residue of prewar debt of less than $200 million. Meanwhile, refunding of the fourth Liberty loan partially tax-exempt bonds, initiated during 1934, was completed by October 1935. The close of 1935 thus saw the end of all federal tax-free bonds incurred during the war, as well as the disappearance of most prewar bonds.[60]

Emergency legislation in 1932 introduced indirect obligations of the United States, issued by government corporations but guaranteed as to principal and/or interest by the government. These were legally contingent obligations of the United States, for which exemption was given from normal taxes as well as excess profits and war profits taxes but not surtaxes.[61] Partially tax-exempt indirect obligations of the United States reached their peak of $5.7 billion in 1941, after which they sharply declined.

In addition, nonguaranteed obligations of certain federal instrumentalities were given exemption from normal taxes.[62] These obligations reached a peak in 1939, when $175 million were outstanding.

The Elimination of Federal Tax Exemption. The new administration at first resisted unilateral action on the elimination of federal tax-exempt securities. Although it viewed the continued

60 This period also witnessed the introduction of new forms of tax-free and partially tax-exempt issues. In 1935, Congress amended the Second Liberty Bond Act to authorize the issuance of United States savings bonds. These were sold on a discount basis for ten-year periods, with accrued interest made exempt from normal taxes. The Adjusted Compensation Payment Act of 1936 provided for immediate redemption of adjusted service certificates, or bonus obligations, originally scheduled for redemption in 1945. These certificates were exchanged for adjusted service bonds, in the amount of $1.7 billion, interest on which was wholly exempt from income tax. See *Annual Report of the Secretary of the Treasury, 1936,* p. 89.

61 They were first issued to the public in 1933 by the Reconstruction Finance Corporation, but did not reach significant amounts until 1935, when sizable issues were distributed by the Federal Farm Mortgage Corporation, the Home Owners' Loan Corporation, and the Reconstruction Finance Corporation. Further obligations were issued by the United States Housing Authority in 1937 and by the Commodity Credit Corporation in 1938.

62 These included securities of the federal home loan banks, first issued in 1937, and of the Federal National Mortgage Association, first issued in 1938. See Appendix D.

exemption of federal securities with misgiving, the Treasury was apprehensive over the effect of its elimination on the market for government bonds so long as the right was preserved for state and local securities.[63] The government was then faced with the problem of financing a large federal deficit as well as extensive refunding of wholly and partially exempt Liberty bonds then maturing.

The Treasury suddenly reversed its policy near the end of 1940, in connection with the financing of a huge rearmament program. It was proposed to finance these expenditures in large part by a $4 billion issue of five-year notes whose redemption would be amortized by an excess profits tax and national-defense "supertaxes," which would increase excises and income taxes generally by 10 per cent. The Secretary announced his intention of making the national-defense notes subject to all federal taxes under the authority of the Second Liberty Bond Act, as amended.[64] In explanation of this move the Secretary stated, "To make this thing fair all around I don't think we should increase the taxes $1,000,000,000 and then give the people who lend the money a special privilege through tax exemption." This step was also initiated apparently in the hope of favorable consideration of the pending Brown bill to end exemption of state and local issues. The Secretary indicated that he wished to reserve his discretion under the Second Liberty Bond Act to issue tax-exempt notes if the tax exemption of state and local issues was not repealed. When the first two defense series of Treasury notes were issued, December

63 The position of the Treasury Department was clarified in a letter of Mar. 6, 1934, from Secretary Morgenthau to the Chairman of the Committee on Finance. This stated that "the Department is compelled to oppose the enactment of legislation which would eliminate the tax exempt feature of future issues of federal obligations while state and local issues would continue to enjoy their constitutional immunity from federal taxation." In a letter to the Chairman of the Senate Judiciary Committee, Mar. 8, 1934, he declared further that "the enactment of legislation requiring federal obligations to be issued in the future on a fully taxable basis in competition with wholly tax exempt securities originating elsewhere, would be likely to react unfavorably on the market for federal securities, to increase the cost of the government's borrowing, and to complicate our financing operations." Reprinted in House Committee on Ways and Means, *Hearings on Proposed Legislation Relating to Tax Exempt Securities,* as cited, p. 462.

64 Senate Committee on Finance, *Hearings on H.R. 10039,* 76th Cong., 3d sess., June 12–14, 1940, p. 19. It will be recalled that the Secretary of the Treasury was given considerable latitude under the terms of issue of federal notes.

18, 1940, and January 31, 1941, they were made subject to all federal income taxes.

The defeat of the bill to eliminate tax exemption of state and local securities, in September 1940, now presented the question whether the Treasury should proceed independently to require future taxation of all its own securities. The Secretary requested Congress to consider this question and had prepared a bill, entitled the Public Debt Act of 1941, which would subject interest on all future United States obligations to federal income taxes.[65] In recommending its approval the Secretary argued that the preferential treatment to high-income groups implicit in tax exemption was "incompatible with democratic financing of the defense program and should be removed." [66] The Treasury conceded that interest costs would be increased up to as much as .25 per cent but expressed no concern over the competition with state and local issues.

The Public Debt Act of 1941 was approved February 19, 1941. It provided that interest on all federal securities issued after February 28, 1941, shall be fully subject to federal income taxes then in effect or enacted in the future.[67] Exemption was retained for territories, possessions, the District of Columbia, and their instrumentalities.

The Treasury had deferred extensive refunding operations pending approval of the act. On February 25, 1941, the Secretary announced the first offering of taxable bonds, dated March 15, 1941, and maturing March 15, 1950, thus inaugurating a new period in federal financial policy. The $52.7 billion of wholly and partially tax-exempt securities of the United States and its instrumentalities which were outstanding at this time were gradually replaced with taxable issues as they matured.

After the passage of the Public Debt Act of 1941, the volume of federal wholly tax-exempt obligations declined sharply from a level of $8 billion in June 1940 to less than $200 million by 1945. Tax-

65 H.R. 2653, 77th Cong., 1st sess., 1941.

66 House Committee on Ways and Means, *Hearings on Public Debt Act of 1941*, 77th Cong., 1st sess., Jan. 29, 1941, p. 5.

67 Public Law 7, H.R. 2959, 77th Cong., 1st sess., 1941. Minor exceptions were made for obligations of the United States Maritime Commission and the Federal Housing Administration contracted before the effective date of the act for future issuance.

exempt bills disappeared by June 1941, but the longer-term notes were not fully retired until 1944. There remain only the 3 per cent Panama Canal loan of 1961, amounting to $50 million, and postal savings bonds, amounting to $74 million, which will mature in 1955. Calling of the Panama Canal bonds in 1961 would thus see the end of all federal wholly tax-exempt bonds.

By the end of 1953, the gross amount of partially tax-exempt bonds had declined from their peak of $35.9 billion to $6.7 billion. Because of their longer maturities their redemption proceeded at a somewhat slower rate than that of the wholly tax-exempt bonds. The last issue of $1.5 billion is not redeemable until December 1960.