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Chapter Title: TAX REVENUES FROM INTEREST

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When the Treasury Department in September 1952 proposed to require banks to file information returns with respect to all payments of interest amounting to \$100 or more in one year, instead of requiring such returns only with respect to interest payments of \$600 or more, the *Wall Street Journal* (Feb. 18, 1953) reported that some holders of savings accounts were dividing up their accounts among a number of banks in order that their interest receipts from any one bank would fall short of \$100 a year. In December 1952 the Treasury withdrew the proposed change in its regulations because of protests from bankers that the change would greatly increase their paper work.

### III. TAX REVENUES FROM INTEREST

1. *Tax revenues from interest income in the 1940's far exceeded those of previous decades, with a growing proportion from the lower taxable incomes*

Since the personal income tax is levied at the same rates on the total from all sources (except for tax-exempt interest and long-term capital gains) of an individual's taxable income, less his personal exemptions and allowable deductions, his tax liability is not strictly made up of separate amounts attributable to each of the various components of his income, such as salaries, dividends, rents, etc.<sup>20</sup> Nevertheless it is useful for some purposes to act as if this were the situation. In practice the additional tax that would be payable on an additional increment of income is often taken into account by investors in choosing the character and form of new investments—as between bonds and common stocks and as between tax-exempt and taxable bonds, for example. This aspect receives attention in the next section of this paper. Because the composition of taxable incomes of the different income groups and the structure of tax rates have varied significantly over a period of years, it is also interesting to measure the varying average impact of the income tax upon the different components of personal incomes. The average effective tax rate for each income group can be calculated by dividing its total tax liability by its total adjusted gross income. By

<sup>20</sup> The effective tax rates on some kinds of income have differed from the formal rates in varying degree from time to time because of exemptions or credits applicable to particular kinds of income. A zero rate, in effect, has been applied without interruption to interest from state and local government obligations and from some obligations of the federal government and its instrumentalities. Interest from large amounts of securities issued by the federal government and its agencies prior to 1941 was exempt from normal tax, although not from surtax. An earned income credit, varying in different years between 1924 and 1943 (not allowable in 1932 and 1933), reduced the effective tax rates on incomes received as compensation for personal services and with different limits, on property income also. Prior to 1936, dividend income was exempt from normal tax. Under the Revenue Act of 1954, the first \$50 of dividend income received by any taxpayer was made wholly exempt from income tax, and a tax credit of 4 per cent of the remainder of his dividend income was made applicable against his total tax liability.

applying the average effective tax rate so obtained to the amount of interest income reported by each income group, a measure of the tax liability that can be attributed to the interest component of taxable incomes may be obtained.<sup>21</sup> In this way interest is not treated as the marginal component of income, subject to the highest applicable bracket rates, but treated as if it were distributed among the various brackets in the same proportions as all other components of income and subject only to the average effective tax rate paid by each person or income group on his or its adjusted gross income as a whole.

Measured in this way, the amount of tax revenue supplied by the interest component of taxable individual incomes in 1918-1950 ranged from a low of \$35 million in 1931 to a high of \$288 million in 1950 (Table 18). In 1918-1920 low personal exemptions, high tax rates, and exceptionally high interest rates (the average yield of Moody's Aaa bonds was 5.49 per cent in 1919 and 6.12 per cent in 1920) contributed to the relatively large revenues from interest in 1918-1920 (\$147, \$135, \$104 million). During 1921-1929 the net effect of more liberal personal exemptions, falling tax rates, and sustained or rising interest income and total income was to produce a fairly stable plateau of income tax revenue from interest, averaging \$79 million annually. The influence of liberalized personal exemptions in 1921 and 1925 is clearly reflected in the declines of those years.

During the 1930's, largely because of the depressed levels of total personal incomes, tax revenues from interest averaged about 36 per cent lower than during the twenties, despite the reduction in personal exemptions and increased in tax rates that began in 1932. A sharp increase in income tax revenues from interest took place during the 1940's with the steep reductions in personal exemptions, increases in tax rates, and growth in the public debt that accompanied the rearmament program and World War II. In 1950 the \$288 million of income tax liability for interest receipts reported on taxable individual returns was more than six times that of 1938 and greater than that of any previous year.

Reflecting the progressive structure of effective income tax rates, inclusive of the personal exemption provisions, the great bulk of the income taxes attributable to interest receipts in all years between 1918 and 1940 was levied on the upper income groups (Table 19). Taxpayers with incomes of \$10,000 or more in this period, though receiving about 46 per cent on the average of the annual amounts of interest

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<sup>21</sup> For some purposes the marginal or highest applicable bracket rate is more significant than the average effective tax rate, as is illustrated presently.

TABLE 18  
INTEREST TAX LIABILITY, BY INCOME GROUPS, 1918-1950  
(Thousands of Dollars)

	Net income classes <sup>a</sup>									Total
	Less than 2	2-3	3-5	5-10	10-25	25-50	50-100	100-500	500 and over	
1918	1,706	2,261	5,675	9,295	17,500	17,322	20,367	45,649	27,647	147,242
1919	1,125	1,168	3,990	7,104	16,626	17,410	20,745	45,849	21,290	135,307
1920	1,399	1,995	4,475	7,707	17,031	16,682	18,281	26,090	10,788	104,452
1921	1,313	1,532	3,166	6,536	14,934	14,044	13,620	16,595	4,878	76,618
1922	1,204	1,559	3,373	7,132	15,697	16,473	18,108	24,375	8,339	96,258
1923	1,434	1,631	4,221	5,562	12,548	12,761	12,688	16,372	5,614	72,831
1924	807	1,009	2,646	2,595	9,382	13,149	15,381	21,908	7,778	74,655
1925	134	365	804	1,705	8,388	12,984	14,066	17,422	6,886	62,755
1926	135	417	756	1,961	9,182	13,666	15,029	19,546	7,800	68,294
1927	89	376	662	2,190	9,897	14,900	16,745	22,890	8,988	76,737
1928	141	490	801	2,313	10,402	15,922	19,076	28,715	16,383	94,242
1929	44	148	254	970	7,869	14,364	17,131	27,341	18,124	86,245
1930	104	415	595	2,148	8,951	12,598	13,085	16,267	7,147	61,310
1931	75	299	412	1,615	6,456	7,542	7,712	7,635	3,329	35,074
1932	992	1,057	1,837	4,821	10,186	11,469	9,789	9,577	2,336	52,066
1933	909	874	1,557	4,059	8,485	9,271	8,204	9,175	2,582	45,118
1934	534	694	1,227	4,376	10,889	10,429	8,401	7,994	2,725	47,266
1935	497	659	1,165	4,164	11,191	11,167	9,842	9,603	2,448	50,736
1936	796	991	1,667	4,110	10,896	12,031	12,730	15,913	6,421	65,556
1937	774	900	1,645	4,131	10,759	11,042	11,214	14,657	6,498	61,620
1938	987	943	1,647	4,060	9,607	8,682	7,110	9,123	4,447	46,606
1939	1,017	1,039	1,776	4,115	10,093	9,966	8,516	11,758	6,040	54,320
1940	1,823	1,294	2,366	5,022	13,661	15,291	12,261	13,563	6,065	71,345
1941	5,871	5,185	9,959	13,954	28,028	23,424	16,941	17,462	5,386	126,211
1942	16,011	11,607	17,937	24,483	42,909	33,922	23,296	21,400	4,544	196,109
1943	16,101	12,549	20,014	31,746	51,050	39,915	29,129	26,835	5,317	232,657
1944	11,422	11,462	20,678	33,553	55,344	42,588	33,042	29,232	10,168	247,489
1945	10,013	11,218	18,488	34,285	58,691	47,042	33,855	28,550	9,694	251,837
1946	9,442	10,250	17,748	32,414	61,081	49,862	38,284	34,909	11,297	265,288
1947	9,918	11,238	18,102	33,541	60,322	49,176	36,603	35,802	11,167	265,867
1948	4,187	6,625	14,970	28,106	45,612	40,519	34,847	38,739	11,827	225,432
1949	5,884	8,392	18,891	33,618	49,050	41,747	34,921	36,099	11,519	240,122
1950	5,445	7,828	18,520	36,819	58,210	54,271	44,351	47,083	15,528	288,054

<sup>a</sup> In 1944 changed to Adjusted Gross Income Classes.

Source: *Statistics of Income*. To the estimated tax liability arrived at as described in the text, we added the tax liability attributable to the interest component of income from fiduciaries received by individuals and beneficiaries. This added tax liability was estimated by the same procedures as those described in the notes to Table 4. However, a slight overestimate of tax liability attributable to interest, of the order of 1 per cent, results from the small duplication in the figures.

TABLE 19  
 SHARES OF INCOME GROUPS IN TOTAL TAX LIABILITY  
 ATTRIBUTABLE TO INTEREST, 1918-1950  
 (Percentages)

	Net income classes* (thousands of dollars)								
	Less than 2	2-3	3-5	5-10	10-25	25-50	50- 100	100- 500	500 and Over
1918	1.2	1.5	3.9	6.3	11.9	11.8	13.8	31.0	18.7
1919	0.8	0.9	2.9	5.3	12.3	12.9	15.3	33.9	15.7
1920	1.3	1.9	4.3	7.4	16.3	16.0	17.5	25.0	10.3
1921	1.7	2.0	4.1	8.5	19.5	18.3	17.8	21.7	6.4
1922	1.3	1.6	3.5	7.4	16.3	17.1	18.8	25.3	8.7
1923	2.0	2.2	5.8	7.6	17.2	17.5	17.4	22.5	7.7
1924	1.1	1.4	3.5	3.5	12.6	17.6	20.6	29.3	10.4
1925	0.2	0.6	1.3	2.7	13.4	20.7	22.4	27.8	11.0
1926	0.2	0.6	1.1	2.9	13.4	20.0	22.0	28.6	11.1
1927	0.1	0.5	0.9	2.9	12.9	19.4	21.8	29.8	11.7
1928	0.1	0.5	0.8	2.5	11.0	16.9	20.2	30.5	17.4
1929	0.1	0.2	0.3	1.1	9.1	16.7	19.9	31.7	21.0
1930	0.2	0.7	1.0	3.5	14.6	20.5	21.3	26.5	11.7
1931	0.2	0.9	1.2	4.6	18.4	21.5	22.0	21.8	9.5
1932	1.9	2.0	3.5	9.3	19.6	22.0	18.8	18.4	4.5
1933	2.0	1.9	3.5	9.0	18.8	20.5	18.2	20.3	5.7
1934	1.1	1.5	2.6	9.3	23.0	22.1	17.8	16.9	5.8
1935	1.0	1.3	2.3	8.2	22.1	22.0	19.4	18.9	4.8
1936	1.2	1.5	2.5	6.3	16.6	18.4	19.4	24.3	9.8
1937	1.3	1.5	2.7	6.7	17.5	17.9	18.2	23.8	10.5
1938	2.1	2.0	3.5	8.7	20.6	18.6	15.3	19.6	9.5
1939	1.9	1.9	3.3	7.6	18.6	18.3	15.7	21.6	11.1
1940	2.6	1.8	3.3	7.0	19.1	21.4	17.2	19.0	8.5
1941	4.7	4.1	7.9	11.1	22.2	18.6	13.4	13.8	4.3
1942	8.2	5.9	9.1	12.5	21.9	17.3	11.9	10.9	2.3
1943	6.9	5.4	8.6	13.6	21.9	17.2	12.5	11.5	2.3
1944	4.6	4.6	8.4	13.6	22.4	17.2	13.4	11.8	4.1
1945	4.0	4.5	7.3	13.6	23.3	18.7	13.4	11.3	3.8
1946	3.6	3.9	6.7	12.2	23.0	18.8	14.4	13.2	4.3
1947	3.7	4.2	6.8	12.6	22.7	18.5	13.8	13.5	4.2
1948	1.9	2.9	6.6	12.5	20.2	18.0	15.5	17.2	5.2
1949	2.5	3.5	7.9	14.0	20.4	17.4	14.5	15.0	4.8
1950	1.9	2.7	6.4	12.8	20.2	18.8	15.4	16.3	5.4

\* In 1944 changed to Adjusted Gross Income Classes.

Note: The figures do not necessarily add to 100 per cent due to rounding!

reported on taxable returns, paid on the average 89 per cent of the annual amounts of income taxes attributable to interest. This extreme relationship was moderated after 1940, partly because of a change in the distribution of reported interest income in favor of the lower income groups and partly because of the relatively greater increases of effective tax rates on smaller than larger incomes. Between 1941 and 1949 inclusive, taxpayers with incomes of \$10,000 or more reported an annual average of 41 per cent of all the interest on taxable returns and paid an annual average of 71 per cent of the income taxes attributable to interest.

2. *Taxes on interest income declined radically as a share of total income taxes, but absorbed one-sixth or more of all interest reported on taxable returns in most years since 1942.*

As a proportion of total personal income tax liability, the amount contributed by interest income ranged during the twenties from 11.2 to 8.1 per cent (Table 20). The proportion rose to 15.8 per cent between 1929 and 1932, when other components of income shrank more drastically during the economic collapse of that period. Thereafter a sharp fall took place that continued with unimportant interruptions for the next twelve years. In 1950, income tax liability attributable to interest accounted for only 1.6 per cent of total personal income tax liability.

Income taxes absorbed a relatively small proportion of total interest income reported on taxable returns during the two decades 1921-1940, the proportion varying between 3.1 and 7.3 per cent (Table 21). It rose sharply in the years following 1940, climbing to 11.0 per cent in 1941, 17.2 in 1942, 21.2 in 1943, 22.9 in 1944, and 23.6 in 1945, after which it gradually declined to 15.9 per cent in 1949 and then rose to 17.8 per cent in 1950.

#### IV. INTEREST INCOME AND INTEREST RATES AFTER TAXES

For the upper income groups, of course, the proportion of interest income absorbed by income taxes rose to much higher levels during the 1940's, and the marginal rates rose higher still. The effective federal tax rates on the first dollar of additional interest or other ordinary income for a married man with two dependent children and the cited amounts of statutory net income from other sources for the years 1940-1954 are shown in Table 22. To these, in states imposing their own income taxes, should be added the marginal tax rates under the state laws.