

**STATISTICS RELATING TO TAX
EXEMPT INCOME**

REPORT

TO THE

**JOINT COMMITTEE ON INTERNAL
REVENUE TAXATION**

BY ITS STAFF

PURSUANT TO

SECTION 1203, REVENUE ACT OF 1926

PRINTED FOR THE
EXAMINATION AND USE OF THE MEMBERS OF THE COMMITTEE

NOTE.—This report has been ordered printed for purposes of information and discussion, but it has not yet been considered or approved by the committee or any member thereof



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STATISTICS RELATING TO TAX-EXEMPT INCOME

INTRODUCTION

The scope of this report is limited to statistical data pertaining to the volume of tax-exempt securities outstanding, the annual interest payments thereon, and the holders of such securities. In addition, there will be presented the data available with respect to the number of governmental employees and the salaries received by them. Part I of the report considers the total volume of tax-exempt securities and the annual interest charged thereon. Part II deals with such securities and interest as are exempt from Federal taxation because of constitutional restraint. Part III presents data relative to securities and interest beyond the taxing power of the States and local units under the Constitution. Part IV includes bonds and their interest, which is wholly or partially exempt from Federal tax because of contractual or statutory exemption. In part V, the advantages of tax-exempt over taxable interest to a taxpayer contemplating investment of funds is shown. Part VI considers the available data regarding the number of governmental employees and their salaries. Part VII offers a brief summary of all the material presented.

In August of 1938, the Division of Research and Statistics of the Treasury Department made a report on securities exempt from the Federal income tax. The Treasury study was very comprehensive in nature and furnishes most of the basic tables included in this report. However, the material will be presented here in a greatly condensed form and from a slightly different approach. It is felt that it will make for clarity if the data are treated, first, from the angle of the Federal taxing power and, second, from the point of view of the State and local power to tax.

PART I. THE TOTAL VOLUME OF TAX-EXEMPT SECURITIES AND INTEREST

There are 182,652 units of government within the United States that have the power to lay and collect taxes and to borrow money. As of June 30, 1937, the gross interest-bearing indebtedness and the gross annual interest charge of these units were as follows:

Types of borrowers	Total	Annual interest
U. S. Government.....	\$35,803,000,000	\$924,000,000
Federal agencies.....	10,547,000,000	224,000,000
State and local governments.....	19,152,000,000	1,795,000,000
Territorial and insular governments.....	146,000,000	8,000,000
Total.....	65,648,000,000	1,951,000,000

¹ Estimated.

Source: All of the basic data contained herein are taken from the Treasury Report, "Securities Exempt from the Federal Income Tax," unless otherwise indicated.

However, a considerable volume of these securities is held by governmental units or governmental agencies in their sinking, trust, and investment funds, and the interest thereon, consequently, does not go to taxable persons. The holdings of these governmental units and agencies are:

Types of borrowers	Total	Annual interest ¹
U. S. Government.....	\$5,967,000,000	\$154,000,000
Federal agencies.....	4,835,000,000	67,000,000
State and local governments.....	¹ 4,298,000,000	¹ 175,000,000
Territorial and insular governments.....	26,000,000	1,000,000
Total.....	¹ 15,126,000,000	¹ 397,000,000

¹ Estimated.

Thus, governments and their agencies hold 23 percent of these securities and receive 21 percent of the total interest payments. There is left a net volume of securities and interest payments to non-governmental holders (who may or may not be taxable) as follows:

Types of borrowers	Total	Annual interest ¹
U. S. Government.....	\$29,836,000,000	\$770,000,000
Federal agencies.....	5,712,000,000	157,000,000
State and local governments.....	¹ 14,854,000,000	620,000,000
Territorial and insular governments.....	120,000,000	7,000,000
Total.....	¹ 50,522,000,000	1,554,000,000

¹ Estimated.

PART II. SECURITIES AND INTEREST BEYOND THE TAXING POWER OF THE FEDERAL GOVERNMENT

This portion of the report will consider the tax-exempt security field from the point of view of the Federal Government. For this purpose, only those bonds and interest payments beyond the Federal taxing power because of constitutional restrictions will be included. The portions that are exempt by statute and by contractual relations will be discussed in part IV.

The gross State and local indebtedness on June 30, 1937, was \$19,595,000,000, of which \$442,000,000 was noninterest bearing. The gross interest bearing debt and the annual interest charge are distributed as follows:

Civil division	Gross interest-bearing debt	Annual interest
State.....	\$3,241,600,000	\$119,000,000
County.....	2,323,300,000	106,000,000
Municipal.....	9,969,000,000	402,000,000
School district.....	1,864,300,000	88,000,000
Other divisions.....	1,754,700,000	80,000,000
Total.....	19,152,900,000	795,000,000

Of this \$19,153,000,000 of gross interest-bearing State and local securities outstanding, governmental units and agencies hold \$4,299,000,000 upon which they receive interest payments of \$175,000,000. This leaves total interest-bearing State and local bonds of \$14,854,000,000 in the hands of private persons (who may or may not be Federal taxpayers), upon which they receive annual interest payments of \$620,000,000.

It will be noted that this interest is computed at an average rate of over 4.1 percent. Since 1900, State and local units floating bond issues have paid widely varying interest rates. Of the total of such securities issued in 1920 and 1921, over half paid interest at greater than 5 percent. Of those issued in 1932, almost 40 percent paid more than 5 percent. Such bonds issued from 1921 to 1932 paid an average of about 4½ percent interest. However, issues since 1934 are paying at greatly reduced rates. Forty-seven percent of those issued in 1935 pay 3 percent or less; 56 percent of those issued in 1936 paid 3 percent or less; and 61 percent of those issued in 1937 paid 3 percent or less. Only 7 percent of those issued in 1937 paid more than 4 percent.

However, as 95 percent of the gross interest-bearing debt of the State and local units is long-term loans, the low current interest rates will not be substantially reflected in the average rate for several years.

Fairly accurate information is available with respect to the issues outstanding, the amounts held by governmental units, and the interest paid thereon. With regard to the private holders of these securities, however, the information is far from complete. Space is provided on the income tax returns of both corporations and individuals for the taxpayer to report the amount of tax-exempt securities held and the interest received therefrom. In the case of corporations, it is felt that the reported holdings and interest are fairly close to the actual figures. In the case of individuals, however, this is not true.

Any distribution of these individual holdings by net income classes is highly conjectural. However, the holdings reported for 1935 by individuals with net incomes in excess of \$5,000, and the interest received, were distributed as follows:

Net income class	State and local securities	
	Held	Interest received
\$5,000 to \$25,000.....	\$855,749,000	\$66,534,000
\$25,000 to \$100,000.....	953,595,000	72,773,000
\$100,000 to \$500,000.....	590,404,000	37,999,000
\$500,000 to \$1,000,000.....	96,845,000	6,548,000
\$1,000,000 and over.....	65,439,000	3,709,000
Total.....	2,562,032,000	187,569,000

The \$5,700,000,000 of State and local bonds estimated by the Treasury to be held by corporations, and the interest therefrom, are distributed by types of corporations as follows:

Types of corporations	Estimated State and local securities	
	Held	Interest received ¹
Mutual savings banks.....	\$831,000,000	\$34,900,000
Other banks.....	2,769,000,000	116,300,000
Life insurance companies.....	1,424,000,000	59,800,000
Other insurance companies.....	322,000,000	13,500,000
Total finance corporations.....	5,346,000,000	224,500,000
Nonfinance corporations.....	359,000,000	15,100,000
Total all corporations.....	5,705,000,000	239,600,000

¹ Computed at the average effective interest rate of 4.1 percent.

There is \$14,854,000,000 in State and local bonds in the hands of private investors upon which a total of \$620,000,000 is paid in interest. From data reported in the Statistics of Income and from information compiled by the Comptroller of the Currency, the Treasury Department estimates the volume of corporate holdings of State and local bonds at \$5,700,000,000. In their income-tax returns, individuals with incomes of more than \$5,000 reported holdings of \$2,562,000,000 and interest received of \$189,000,000. These figures would indicate an interest rate of 7 percent, which is almost 3 percent above the average actually paid. Even at the 4.1 percent average rate, the interest reported indicates holdings by individuals of State and local issues of only \$4,600,000,000.

Obviously, these statistics greatly underrate individual holdings. The Treasury Department estimates that individuals with net incomes of less than \$5,000 hold \$500,000,000 of these bonds. By computing the holdings of individuals with net incomes in excess of \$5,000 by interest reported rather than by the actual holdings reported, and by adding the estimate of holdings by individuals of less than \$5,000 net incomes, there is only \$10,800,000,000 of the \$14,854,000,000 of net outstanding State and local issues accounted for.

Undoubtedly, there are private holders who are exempt from tax by statute, and consequently file no returns, who hold some of these securities. But the amount cannot be substantial and is of no great importance to this study.

Some indication of the holders of the \$4,000,000,000 volume of these securities unaccounted for may be gained by reference to the estate-tax returns. Since 1927, the estates of decedents for which estate-tax returns were filed contained State and local securities as follows:

1927.....	\$117,000,000	1933.....	\$158,000,000
1928.....	137,000,000	1934.....	196,000,000
1929.....	149,000,000	1935.....	174,000,000
1930.....	180,000,000	1936.....	136,000,000
1931.....	228,000,000	1937.....	166,000,000
1932.....	192,000,000		

Source: Statistics of Income.

PART III. SECURITIES AND INTEREST BEYOND THE TAXING POWER OF THE STATES AND LOCAL GOVERNMENTS

Here will be considered the governmental securities and interest which, under the Constitution, the States and local governments are forbidden to tax. The scope, therefore, is limited to the securities of the Federal Government, the Federal agencies, and the Territorial and insular governments.

As of June 30, 1937, the gross amounts of these securities and the gross interest paid was:

Types of borrowers	Securities outstanding	Interest paid
United States Government.....	\$35,803,000,000	\$924,000,000
Federal agencies.....	10,547,000,000	224,000,000
Territorial and insular possessions.....	146,000,000	8,000,000
Total.....	46,496,000,000	1,156,000,000

Of this volume of securities outstanding, governmental units and agencies themselves held \$10,828,000,000 and received in interest \$222,000,000 distributed by types of borrowers as follows:

Types of borrowers	Securities	Interest
United States Government.....	\$5,967,000,000	\$154,000,000
Federal agencies.....	4,835,000,000	67,000,000
Territorial and insular possessions.....	26,000,000	1,000,000
Total.....	10,828,000,000	222,000,000

The units of Government and governmental agencies holding these securities were as follows:

Types of holders	Types of borrowers		
	United States Government	United States agencies	Territorial and insular possessions
U. S. Government.....		\$3,630,000,000	
United States agencies.....	\$1,477,000,000	1,160,000,000	
United States trust funds.....	1,703,000,000	45,000,000	
State and local government.....	261,000,000		
Federal Reserve banks.....	2,526,000,000		
Territorial and insular possessions.....			\$26,000,000
Total.....	5,967,000,000	4,835,000,000	26,000,000

Thus, out of the \$46,496,000,000 of gross interest-bearing securities of the Federal Government and its agencies and possessions, governmental units and agencies themselves hold over 23 percent and receive over 19 percent of the total interest charge. There is left a

net volume of such securities and interest in the hands of nongovernmental holders (who may or may not be taxable) as follows:

Types of borrowers	Securities	Interest
United States Government.....	\$29,836,000,000	\$770,000,000
Federal agencies.....	5,712,000,000	157,000,000
Territorial and insular possessions.....	120,000,000	7,000,000
Total.....	35,668,000,000	934,000,000

With regard to the portion of these securities held by corporations, the Treasury estimate sets the volume at \$24,334,000,000, distributed by holders as follows:

Type of corporation	United States Government and Federal agency securities	
	Held	Interest received ¹
Mutual savings banks.....	\$2,400,000,000	\$62,880,000
Other banks.....	14,916,000,000	390,800,000
Life insurance companies.....	4,416,000,000	115,700,000
Other insurance companies.....	835,000,000	21,875,000
Total, finance corporations.....	22,567,000,000	591,255,000
Nonfinance corporations.....	1,767,000,000	46,295,000
Total, all corporations.....	24,334,000,000	637,550,000

¹ Computed at the average effective rate of 2.62 percent.

It is felt that these figures represent with fair accuracy the actual holdings of these groups. The data with respect to individual holdings are known to be far from complete, however. In their income-tax returns for 1936, individuals with net incomes in excess of \$5,000 reported holdings of Federal bonds and the securities of Federal agencies, along with the interest received, as follows:

Net income classes	U. S. Government and Federal agency securities		
	Held	Interest received	Rate
Under \$5,000 ¹	¹ \$827,000,000	¹ \$21,667,000	Percent ¹ 2.62
\$5,000 to \$25,000.....	937,773,000	40,206,000	4.29
\$25,000 to \$100,000.....	564,427,000	27,467,000	4.87
\$100,000 to \$500,000.....	869,430,000	13,236,000	3.58
\$500,000 to \$1,000,000.....	75,951,000	2,015,000	2.65
\$1,000,000 and over.....	137,408,000	2,846,000	2.07
	2,084,989,000	85,770,000	4.11
	827,000,000	21,667,000	2.62
	2,911,989,000	107,437,000	3.69

¹ Estimated.

To these holdings actually reported has been added the Treasury's estimate of the holdings of persons with net incomes of less than \$5,000, which was made from a study of returns filed for 1934.

As is the case with the reported holdings by individuals of State and local bonds, it is obvious that the above figures greatly understate the actual holdings. The interest reported by individuals indicated a return of 4.11 percent on the holdings reported, while the average interest rate on Federal bonds and Federal agency securities was 2.62 percent. Even if the interest reported were used as a measure rather than the reported holdings themselves, a volume of only \$4,100,000 of individual holdings would be indicated, leaving holdings of over \$7,000,000,000 and interest of almost \$200,000,000 unaccounted for.

Some further evidence of the amount of these securities held by individuals may be gained by reference to the amounts of such bonds found in the estates of decedents for which estate tax returns have been filed. For the years 1927 to 1937, inclusive, the estate tax returns disclose the following amounts of Federal and Federal agency securities in the estates of decedents dying during that period:

1927-----	\$117, 000, 000	1933-----	\$103, 000, 000
1928-----	110, 000, 000	1934-----	127, 000, 000
1929-----	91, 000, 000	1935-----	139, 000, 000
1930-----	122, 000, 000	1936-----	111, 000, 000
1931-----	128, 000, 000	1937-----	139, 000, 000
1932-----	95, 000, 000		

Source: Statistics of Income.

PART IV. SECURITIES AND INTEREST WHOLLY OR PARTIALLY EXEMPT FROM FEDERAL TAX BECAUSE OF CONTRACTUAL AND STATUTORY RESTRAINT

In addition to those securities and interest beyond the Federal taxing power because of constitutional prohibition (State and local securities and interest), all interest from Federal securities and the securities of Federal agencies is either wholly or partially exempt from Federal tax by statute and by contract with the holders. These securities are identical with those discussed in part III.

As of June 30, 1937, the volume of these securities by types of borrowers was:

Types of borrowers	Wholly exempt	Partially exempt
U. S. Government-----	\$15, 065, 000, 000	\$20, 738, 000, 000
Federal Farm Loan System-----	2, 228, 000, 000	1, 422, 000, 000
Federal Home Loan System-----		3, 037, 000, 000
Reconstruction Finance Corporation-----		3, 860, 000, 000
Territories and possessions-----	146, 000, 000	
Total-----	17, 439, 000, 000	29, 057, 000, 000

Of this \$46,496,000,000 of gross interest-bearing securities of the Federal Government, its agencies and possessions, governmental units and agencies themselves hold \$10,828,000,000, leaving outstanding in the hands of private persons (who may or may not be taxable)

\$35,668,000,000 of such securities, distributed by types of borrowers as follows:

Types of borrowers	Wholly exempt	Partially exempt
U. S. Government	\$11,600,000,000	\$18,236,000,000
Federal Farm Loan System.....	1,393,000,000	1,244,000,000
Federal Home Loan System.....		2,820,000,000
Reconstruction Finance Corporation.....		255,000,000
Territories and possessions.....	120,000,000	
Total.....	13,113,000,000	22,555,000,000

The estimated annual interest on this net volume of outstanding securities (computed at the average combined rate of 2.62 percent) is \$343,000,000 for the wholly exempt securities and \$591,000,000 for those partially exempt, or a total of \$934,000,000.

Thus, by statute and by contract with the purchasers of Federal securities and the securities of Federal agencies, the Federal Government has exempted from the normal income tax the interest on \$29,057,000,000 of securities, \$22,555,000,000 of which is in the hands of private persons who may be taxable; and has exempted from both the normal and surtax the interest from \$17,439,000,000, of which \$13,113,000,000 is in the hands of private persons.

PART V. THE ADVANTAGES TO TAXPAYERS OF NONTAXABLE OVER TAXABLE INVESTMENT YIELDS

Under the high surtax rates now in effect the advantages of tax-exempt interest over taxable yields to taxpayers in the upper income brackets reach substantial proportions. For the purpose of showing the approximate points at which it becomes profitable for taxpayers to abandon the general business and investment field and to invest their capital in tax-exempt securities, the following material and discussion is submitted.

The data shown have to do only with the avoidance of Federal income tax although in almost every instance the holders of tax-exempt securities avoid taxes other than this by reason of their holding. For example, the holders of Federal securities, the interest from which is wholly exempt from Federal income tax, avoid not only the Federal tax but the State income tax as well. In addition, ad valorem taxes, and other levies, are prevented.

After settling upon the tax-exempt security desired and determining the interest payable thereon, the taxpayer may readily compute an investment schedule that will produce the maximum return after tax, if he is able to forecast with fair accuracy the probable taxable yield as well as the nontaxable. For example, a taxpayer with \$10,000,000 of capital to invest finds he can get a taxable return of 7 percent and a nontaxable return of 3 percent.

If he were to invest his total capital in the 7 percent venture his return of \$700,000 would pay a Federal income tax of \$452,000, or almost 65 percent, leaving a net return of \$248,000. He could get a net return of \$300,000, or \$52,000 greater by investing his entire capital at 3 percent nontaxable. His greatest return, however, will be achieved by investing approximately \$1,286,000 in the 7-percent

venture and the balance of \$8,714,000 in 3 percent tax-exempt securities. His situation would then be:

Capital:	<i>Income</i>
\$1,286,000 at 7 percent (taxable)-----	\$90,020
Income tax-----	26,680
Net after tax-----	63,340
\$8,714,000 at 3 percent (nontaxable)-----	261,420
Total-----	324,760

Thus, while his income, before tax, is reduced from \$700,000 to \$351,440 (\$90,020 taxable and \$261,420 nontaxable), his net return after tax is increased from \$248,000 to \$324,760, or 31 percent, by the judicious employment of tax-exempt interest. Of course, this example is rather exaggerated but it does serve to show the possibilities of substantial tax savings by the purchase of tax-exempt bonds.

The reason underlying this particular taxpayer's advantage in keeping his taxable net income from exceeding \$90,000, is that at that point the combined normal and surtax rates increase from 55 to 59 percent. It is no longer advantageous for this taxpayer to prefer a 7 percent taxable return to a nontaxable yield of 3 percent if his taxable net income reaches a bracket where a tax rate greater than 57 percent is applicable; 57.14 percent being the differential between 7 and 3.

This proposition may be reduced to a generally applicable formula. Tax-exempt investments are profitable only so long as they reduce the taxable net income of the taxpayer to the point where it will not fall into a bracket subject to a tax rate greater than the differential between the expected taxable and nontaxable yields. This breaking point may be demonstrated by the following brief table. When the combined normal and surtax rate applicable exceeds the indicated tax rate in the case where any given taxable and nontaxable yield is open to the investor, it becomes beneficial to adopt the nontaxable rather than the taxable yield.

Taxable yields (percent)	Nontaxable yields (percent)					
	1.0	2.0	3.0	4.0	5.0	6.0
Combined normal and surtax rates at which the indicated taxable yield, after tax, equals the indicated nontaxable yield						
2.0-----	50.00					
3.0-----	66.67	33.33				
4.0-----	75.00	50.00	25.00			
5.0-----		60.00	40.00	20.00		
6.0-----		66.67	50.00	33.33	16.67	
7.0-----		71.43	57.14	42.89	28.57	14.29
8.0-----		75.00	62.50	50.00	37.50	25.00
9.0-----			66.67	55.56	44.44	33.00
10.0-----			70.00	60.00	50.00	40.00
11.0-----				72.72	63.63	54.54
12.0-----				75.00	66.67	58.17
14.0-----					71.43	64.29
16.0-----					75.00	68.75
18.0-----						72.72
20.0-----						75.00
22.0-----						
24.0-----						
						75.00

PART VI. GOVERNMENTAL EMPLOYEES AND THEIR COMPENSATION

In 1936 the total number of governmental employees was 3,445,339, to whom \$4,975,000,000 was paid in compensation. These employees were distributed among the various governmental units as follows:

Employing unit	Number of employees	Total pay roll	Average wage
U. S. Government:			
Executive service.....	820, 898	\$1, 531, 105, 000	\$1, 865
Military service.....	298, 734	274, 640, 000	919
Judicial service.....	1, 917	5, 946, 000	3, 102
Legislative service.....	5, 149	14, 429, 000	2, 802
Total, United States.....	1, 126, 698	1, 826, 120, 000	1, 621
State and local:			
State.....	358, 952	525, 794, 000	1, 465
County, etc.....	285, 461	416, 379, 000	1, 459
City.....	674, 342	1, 150, 346, 000	1, 706
Public education.....	1, 187, 576	1, 477, 443, 000	1, 244
Total, State and local.....	2, 506, 331	3, 569, 962, 000	1, 424
Grand total.....	3, 633, 029	5, 396, 082, 000	1, 485

Source: National Income Section, Bureau of Foreign and Domestic Commerce.

In 1937 the number of employees of all governmental units increased to 3,764,000 and the pay roll increased to \$5,659,000,000, an average wage of \$1,503.

An examination of the figures for back years discloses that there has been a steady increase in the number of governmental employees. For example, in 1929 the number was 3,123,000; in 1930, 3,229,000; in 1931, 3,265,000; in 1934, 3,337,000; and in 1937, 3,764,000. Thus, in this 9-year period the number increased 641,000, or almost 21 per cent. During the same period, the total compensation increased from \$5,386,000,000 to \$5,659,000,000, an increase of \$273,000,000, or 5 per cent. The average wage, however, has decreased during the same period from \$1,725 to \$1,503, or 13 per cent.

Thus, there is \$3,569,000,000 in compensation going annually to 2,506,000 State and local employees. The greater part of this sum is beyond the Federal taxing power. However, a considerable portion goes to employees engaged in functions which, under the Supreme Court's decisions, will permit of Federal taxation. It is expected that data may soon be available that will support at least a reasonably accurate estimate of the portions of this sum falling into the taxable and nontaxable categories.

With regard to the \$1,826,000,000 going in compensation to the 1,127,000 Federal employees, all of this is beyond the State and local taxing power under the Court's decisions.

It is expected that there will be available a distribution of both the employees and their compensation by income brackets in the near future. When such a distribution is available, it will aid materially in allowing an approximation of the tax revenue that would be secured through an elimination of the exemption.

PART VII. SUMMARY

As of June 30, 1937, the gross interest-bearing debt of all governmental units and agencies was \$65,648,000,000 upon which the annual interest charge was \$1,951,000,000. After deducting the securities held and the interest received by these units and their agencies, there existed a net volume of securities in the hands of private persons of \$50,522,000,000 upon which the annual interest charge was \$1,554,000,000.

Of these net sums, \$14,854,000,000 represents State and local securities and \$35,668,000,000 bonds of the Federal Government and its agencies; and with regard to interest, \$620,000,000 represents interest on State and local securities and \$934,000,000 is the interest charge on the net outstanding issues of the Federal Government and its agencies. These securities, and the interest thereon, are mutually exempt from taxation by the other government by constitutional restrictions. In addition, the \$934,000,000 of net interest, on United States and Federal agency securities, going to private persons, is either wholly or partially exempt from Federal income tax by statute and by contract.

As of 1937, there were 3,764,000 governmental employees, drawing \$5,659,000,000 in compensation, most of which was exempt from taxation by the Government other than that for which they worked.

Of these, 1,202,000 were Federal employees, drawing \$1,198,000,000 in compensation, all of which was beyond the taxing power of the State and local governments. The balance of 2,562,000 were State and local employees, to whom \$3,741,000,000 was paid in compensation, the greater portion of which is exempt from the Federal income tax.

Thus, because of constitutional restraints, the Federal Government is unable to tax \$620,000,000 in interest, in the hands of private persons (who may or may not be taxable otherwise), and the greater part of \$3,741,000,000 of wages and salaries of State and local employees. In addition, the Federal income tax is applied only partially, or not at all, to \$934,000,000 in interest, in the hands of private persons (who may or may not be taxable otherwise) because of statutory and contractual provisions.

