DESCRIPTION OF ADMINISTRATION PROPOSALS ON INCREASING THE PUBLIC DEBT LIMIT AND DEBT MANAGEMENT

Scheduled for a Public Hearing

Before the

COMMITTEE ON FINANCE

on May 27, 1982

Prepared for the

COMMITTEE ON FINANCE

By the

Staff of the Joint Committee on Taxation

May 26, 1982

JCX-22-82

CONTENTS

INTRODUCTION

The Committee on Finance has scheduled a public hearing on May 27, 1982, on the Administration's proposals (1) to increase the public debt limit, (2) to institute an administrative program to pay a market-related interest rate on U.S. savings bonds, and (3) to repeal the interest rate ceiling on long-term bonds (obligations with maturity of more than 10 years).

The first part of this document is a summary of the Administration's proposals. The second part is a more detailed description of the proposals,including present law, issues, explanation of the proposals, and analysis of the proposals.

I. SUMMARY

Public debt limit

The public debt limit presently is $1,079.8 billion through fiscal year 1982, i.e., through September 30, 1982. The limit consists of a $400 billion permanent limit and a $679.8 billion temporary limit that is in effect through September 1982.

The present limit will not meet Federal financing requirements for the rest of this fiscal year. Treasury estimates that its present debt management program would require enacement of an increased debt limit by the third week in June in order to complete the issue of new 4-year notes on June 30. In addition, very substantial expenditures for social security benefit payments, various retirement programs and payrolls on June 30 and the first three days in July also require timely action on the debt limit in June.

Savings bond interest rates

The Second Liberty Bond Act provides that the Secretary of the Treasury, with the consent of the President, may increase the maximum interest rate on U.S. savings bonds, Series EE and HH, by not more than 1 percentage point in any six-month period. The Administration last exercised this authority on May 1, 1981, when the yield on Series EE bonds was increased to 9 percent and the yield on Series HH to 8-1/2 percent.

The Administration has proposed that this limitation be repealed and replaced by a provision that would authorize the Secretary of the Treasury to establish interest rates related to current market rates of interest. Treasury intends to use this authority to issue a market rate savings bond whose holders would be guaranteed minimum interest rates that would rise gradually through the first five years after purchase. Bonds held longer than 5 years would earn interest at a rate equal to 85 percent of the average market yield on 5-year Treasury securities, or the guaranteed minimum rate, whichever is higher.

Interest rate on bonds

The Secretary of the Treasury may issue to the public up to $70 billion in bonds, i.e., obligations that mature more than 10 years after the date of issue, that bear an interest rate in excess of 4-1/4 percent. Treasury has exhausted the $70 billion authority for the exception. No interest rate limitation has been placed on obligations with shorter maturities, e.g., notes, certificates and bills.

The Administration has proposed repeal of the 4-1/4 percent limitation on the rate of interest that may be paid on bonds.

II. DESCRIPTION OF ADMINISTRATION PROPOSALS

A. Increase in the Public Debt

Present law

The combined permanent and temporary debt limit is $1,079.8 billion, which is in effect through September 30, 1982. This limit is the combination of the permanent debt limit of $400 billion, which has no expiration date, and the temporary debt limit of $679.8 billion, which will expire after September 30, 1982.

Current debt situation

The outstanding public debt was $1,069.4 billion at the close of business on May 21, 1982. Treasury estimates that the $10 billion in unused debt limit will be sufficient for the financing needs of the Federal Government through most of June 1982. Treasury has indicated also that the increased debt limit should be passed by the third week of June, so that it may carry out present debt management plans to announce, auction and settle by June 30 on an issue of 4-year notes.

Administration proposal

The Administration is requesting that the public debt limit be increased by $195 billion over the present limit to $1,275 through fiscal year 1983. This level is consistent with the Administration's estimate of a $1,265 billion debt through fiscal year 1983, which was estimated for the April revision of the budget; $1,131.8 billion was the estimate of the level at the end of fiscal year 1982. Treasury has increased the estimate by $10 billion in order to raise the level of the operating cash balance from $15 to $20 billion and to provide a $5 billion allowance for contingencies. In recent years, the operating cash balance at the end of September has been greater than $20 billion, and Treasury's request seeks to recognize that experience in setting the public debt limit. An allowance for contingencies is needed in recognition of the uncertainties inherent in making debt limit projections 16 months into the future and the risks involved in the higher average monthly levels of receipts and expenditures with current budget totals.

Senate budget resolution

In adopting a budget resolution (S. Con. Res. 92) last week, the Senate specified the appropriate levels of the public debt at $1,144.2 billion through fiscal year 1982 and $1,292.3 billion through fiscal year 1983.

B. Rate of Interest Payable on U.S. Savings Bonds

Present law

The Secretary of the Treasury has discretionary authority to set the rate of interest on savings bonds and savings certificates within certain statutory limits. The minimum investment yield on Series EE savings bonds may not be less than 4 percent (annual rate, compounded semiannually from the date of issuance). There is a statutory maximum interest rate of 5-1/2 percent,but statutory exceptions and exercise of administrative discretionary authority have resulted in the current rates.

The Secretary, with the approval of the President, may increase the investment yeild on any U.S. savings bond above the current rate in any six-month period by no more than 1 percentage point (annual rate compounded semiannually). The authority to make such increases enables the Secretary to increase the rate of interest above the statutory limit and to keep the rate competitive with comparable alternative yields.

Series EE savings bonds now yield 9 percent, compounded semi-annually, when the bonds are held to maturity, which is an 8 year period now. The yield on Series HH bonds is 8-1/2 percent. These bonds have a maturity of 10 years, and the interest is paid semiannually by check. The Secretary used his discretionary authority to put these rates into effect on May 1, 1981. He has not exercised this authority since then. Series EE and HH bonds are not marketable securities.

No person may purchase more than $15,000 in Series EE bonds, at issue price, in any one year. The limit on purchases of Series HH bonds is $20,000.

Section 454 of the Internal Revenue Code, relating to obligations issued at discount, provides the authority for deferral of income tax on the appreciation accrued annually on a Series EE bond. Section 454(a) provides that for a taxpayer on the cash accounting method who holds non-interest bearing obligations issued at discount and redeemable for fixed amounts at stated intervals, the increase in value does not constitute income to him in a taxable year until the bond is redeemed. The taxpayer may elect to include the increased value in gross income each year and, once having made such an election, is bound by the election for all subsequent taxable years until the bond is redeemed. The same privilege is available, in section 454(c), to a Series E savings bond that has matured and has not been redeemed by the taxpayer. The privilege has been extended to Series EE bonds by administrative action. The increase in redemption value is not includible in gross income until the taxable year in which the bond is redeemed.

Reasons for the proposal

The general increase in the structure of interest rates in recent years has resulted in a net increase of redemptions over sales of U.S. savings bonds. In the past 3 years, redemptions have exceeded sales by more than $25 billion. The Secretary's discretionary authority to raise the interest rate on savings bonds was used last on May 1, 1981, to raise the rates on Series EE bonds to 9 percent and to 8-1/2 percent on Series HH bonds.

Treasury did not use its authority to increase the rate on Series EE bonds to 10 percent on November 1, 1981, and it announced then that it would seek legislation to permit varying the savings bond rate with current market rates. The Secretary has stated that increasing the savings bond rate might reduce the net redemptions, but it is an expensive alternative in the long run, if market interest rates declined. Therefore, the Administration has decided to seek discretionary authority to increase or decrease savings bonds interest rates as comparable market rates change.

Explanation of Administration's proposed legislation

The Administration proposal would authorize the Secretary, with the approval of the President, to issue U.S. savings bonds that could assure long-term savers that the rate on savings bonds would continue to be competitive with current market rates. The proposal is that people holding either new or old bonds for at least 5 years from the beginning of the new program will be assured that the return will be no less than 85 percent of the average return on 5-year Treasury marketables during their holding period. They also will be guaranteed a minimum rate, so that they will receive 85 percent of the average market yield on 5-year Treasury securities over the holding period, or the guaranteed minimum rate, whichever is higher.

The rate paid on savings bonds would be less than the marketable rate for several reasons: (1) savings bonds are available in smaller minimum denominations than Treasury marketable debt issues and therefore entail higher administrative costs; (2) savings bonds have tax deferral advantages which increase their effective yield after taxes (relative to marketable securities); and (3) savings bonds are redeemable at par, thereby eliminating the risk of market value depreciation inherent in ownership of marketable Treasury notes. On this basis, a rate on savings bonds equal to 85 percent of the rate on marketable Treasury five-year notes is considered to be a fair rate of return. The amount of savings bonds outstanding would continue to be included within the limit established by the Congress for the public debt. Proceeds from the issue of savings bonds would continue to be available--just as the proceeds from other obligations--to meet public expenditures and to retire outstanding obligations of the United States.

The Secretary would be authorized to promulgate regulations that would allow savings bonds owners to retain bonds for any period beyond original maturity and to continue to earn interest during the period the bond is held. In addition, the yield on savings bonds could be increased for the period remaining to maturity or during the period of extended maturity, or the yield could be changed for any new extension period.

Staff analysis

Treasury proposes that the Secretary be given authority to establish a market-related interest rate for savings bonds.

The new savings bonds would continue to have a guaranteed minimum interest rate which would rise through the first 5 years after purchase to the market-related yield or the guaranteed minimum yield. The maximum rate of interest would be paid on savings bonds held for 5 years or longer and would be no less than 85 percent of the average return on 5-year Treasury marketable securities during the holding period. People who would hold either new or old bonds for at least 5 years from the beginning of the program would be assured or receiving the higher of 85 percent of this average market rate of interest or a guaranteed minimum rate of interest beginning in the sixth year. Bonds held beyond the stated maturity period that otherwise meet requirements would continue to be eligible for the greater of 85 percent of the market rate or a guaranteed minimum rate of interest. New issues of Series EE bonds would receive yields related to current market rates of interest.

A small investor, i.e., one who could not invest $1,000 at once, could find the Series EE bond attractive. This investor has an alternative in a passbook account with a saving and loan presently yielding 5.5 percent (5.25 percent at a commercial bank). Income tax would be payable on the interest earnings, but the after-tax yield could remain in the account and accrue the benefits of compounding. Commercial banks and savings and loan associations now offer a considerable variety of savings instruments with different yields, maturities and minimum investment requirements. The deregulation of banks, as presently scheduled during the next four years, should improve their ability to compete for and hold deposits. Savers in the future will have more savings instruments to select from to satisfy their own requirements.

The proposed savings bond would be attractive to these savers if the after-tax yield at the time of redemption is greater than the alternative private yields. The financial benefits of the savings bonds are the deferral of tax on the compounded yield while the bond is outstanding and the potential that the average yield during these years produces a greater after-tax yield than the same small saver could get from his alternatives.

C. 4-1/4 Percent Limit on Interest Rate on Bonds

Present law

Bonds are U.S. obligations that have a maturity when issued that is longer than 10 years. The rate of interest that may be paid on a bond may not exceed 4-1/4 percent, except that up to $70 billion in outstanding bonds with rates of interest above 4-1/4 percent may be held by the public. The exception for a specified amount of bonds--initially $10 billion--was enacted in 1971, and it applied to all bonds with rates above the ceiling. An amendment in 1973 applied the $10 billion limitation only to bonds held by the public. The last increase in the limit was enacted in October 1980, and it raised the limit to $70 billion.

Reasons for the proposed legislation

The 4-1/4 percent interest rate ceiling has been substantially below current market rates since the mid-1960's. The most recent bond auction, in February 1982, required an interest coupon of 14 percent. Treasury believes that there is no prospect in the forseeable future that bond market rates will fall to 4-1/4 percent.

Treasury has exhausted its $70 billion authority to issue long-term bonds and was forced to cancel its regular quarterly issues of 20-year bonds in April and 30-year bonds in May. Treasury believes it must continue to issue bonds to maintain a presence in all maturity sectors of the bond market and to resist shortening the maturity of the public debt. About half of the privately held marketable debt matures in one year and two-thirds within 2 years. The average maturity was 4 years and one month at the end of February 1982.

Interruption of Treasury's quarterly bond cycle may also disrupt the bond market. Disruption would occur because of market uncertainty about Treasury plans and how to allocate investable funds among private and public issues and among different maturities. In addition, Treasury believes that maintaining a stable bond market reduces borrowing costs in the long run, even though the interest rate when a bond is issued may be high in terms of historical patterns. Bonds issued at high interest rates lock-in the Treasury to pay those rates until the bonds are redeemed, more than 10 years after the issue date.

Explanation of the Administration proposal

The proposal would repeal the provision in the Second Liberty Bond Act (31 U.S.C. 752) that limits the rate of interest on United States Bonds to 4-1/4 percent.

In addition, as a conforming amendment, the proposal would repeal the exception to the 4-1/4 percent ceiling that now limits the amounts that may be issued at rates above 4-1/4 percent and held by the public to $70 billion.

As a result, the Treasury would be able to issue bonds at the prevailing market rate, in amounts the market could absorb, and as frequently as the Secretary determines to be appropriate.

Staff analysis

Between World War II and the beginning of the 1970's, there was a steady shortening of the maturity structure of the Federal debt. In 1946, the average maturity of the debt was 9 years, and by 1976 it had shrunk to 2-1/2 years. This trend was partly a result of statutory limitations on the issuance of long-term debt by the Treasury and partly a result of small increases in the debt outstanding in the market during most of this period. Since the mid-1970's, the Treasury has succeeded in increasing the average maturity to 4 years. The Treasury proposal to remove the statutory cap on long-term bond issues is needed to enable Treasury to continue with the policy.

Arguments for lengthening the maturity of the Federal debt.--Proponents of legislation to permit further lengthening of the maturity of the Federal debt argue that securities with longer maturities are cheaper for the government in the sense that they will involve lower administrative costs. Because the government must come to the market less frequently when it issues longer-term debt, there is less risk of disrupting private securities markets. They also argue that, in view of the large federal deficits which are forecast, Treasury must offer as wide a range of maturities as possible in order to market successfully its huge volume of debt.

It is also contended that Treasury's continuing to issue long-term bonds also helps other sectors of the money market. The prices on actively traded Treasury issues are used as benchmarks in pricing private bond issues, thereby reducing risks to underwriters of those issues. Treasury bond issues also support options and futures markets which are used by portfolio managers to hedge risks.

Arguments against lengthening the maturity on the Federal debt.--Interest rates typically are higher on long-term bonds than on short-term securities, in which case long-term bonds will involve higher outlays for interest. The risk of locking Treasury into a costly interest burden is considered by some analysts to be especially great today, when interest rates embody a sizable inflation premium and when the government itself is predicting substantial declines in interest rates.

Furthermore, there is currently a shortage of lenders willing to commit funds at fixed interest rates for long periods of time. When the Federal Government issues long-term bonds, it tends to crowd other borrowers out of the long-term market. This could have the effect of reducing mortgage lending and of forcing corporations to borrow short-term more than they otherwise would prefer, which increases the risk that they will run into financial difficulties. Some also contend that it is inconsistent for the government to enact credit or subsidy programs to encourage lenders to commit funds to the mortgage market and, at the same time, to crowd those same borrowers out of the long-term market with Treasury bond issues.

Possible alternatives to long-term bond issues.--Several alternatives have been suggested to Treasury issuance of more long-term bonds. These might give Treasury some of the advantages of long-term financing without the ill-effects of fixed-rate long-term bonds. One possibility would be for Treasury to issue a long-term bond with a floating interest rate. Another would be for Treasury to issue a bond whose interest and principal payments were indexed to inflation.

The issuing of these kinds of obligations also would require repeal of the present 4-1/4 percent interest rate ceiling.

The average maturity of the debt could be increased by issuing notes with maturities of 5 to 10 years. There is no interest rate limitation on obligations which are scheduled to mature within 10 years of the issue date.