BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

From Ralph Young, Thomas Smith, Merton Miller

Subject: Comments on a Proposal to Encourage the Sale of Savings Bonds by Limited Tax Exemption

I. The Proposal

A proposal has been made to encourage the purchase of savings bonds (Series E, F and G) by individuals (and to give a certain amount of tax relief) by permitting tax exemption of the interest payments on savings bonds up to some limit, such as $500 per individual.

II. Conclusions Concerning the Merits of the Proposal

The proposal would not accomplish the purpose of stimulating significantly savings bonds sales. It would have little or no anti-inflationary effect and might actually be definitely inflationary. It would materially increase the cost of carrying the public debt. It would constitute a reversal of basic tax policy with respect to interest income from Government securities.

III. Effect on Existing Savings Bonds

If one major purpose is to give an immediate tax relief by the measure, E and F bonds would need to be converted from a discount to a coupon basis. If they were not so converted, there would be no tax relief to holders of these bonds in the current year. There would also be no immediate incentive to purchase as far as these issues are concerned. On the other hand, if these bonds were converted, cash in the hands of the public would be increased by the amount of the interest (over a billion a year) thus giving the plan a handicap of this amount before it could be said to exert any anti-inflationary effect.

IV. Effect of the Plan on the Cost of Carrying the Debt

Ultimately, the total interest payments on outstanding E, F and G bonds, if held to maturity, would be over 15 billion dollars. Of this amount, 3 to 5 billion dollars would be recovered in taxes. If the plan goes into effect, however, at least 2/3 of this tax recovery will be lost. As a result, the cost of carrying the debt (and the amount of taxes which will have to be raised from other sources of income) will increase by this amount over the life of the bonds.

V. Effectiveness of the Exemption as Incentive to Purchase

The effectiveness of any tax incentive device depends largely on the tax rates involved. In the case of personal income tax, these rates increase with income and hence the incentive to purchase would also increase as income rises. For a low income individual who is not taxable or who expects to become nontaxable as a result of probable future increases in exemptions, there is no incentive whatsoever. For an individual taxable at the first surtax bracket rate of 19 per cent, the incentive is relatively small. It is equivalent to a hidden rise in the interest rate on a 2 1/2 per cent bond to 3.1 per cent. On the other hand, to an individual in the upper end of the income scale and subject to the maximum surtax rate of 85.5 per cent, the tax exemption is equivalent to a hidden rise in the interest rate from 2.5 per cent to 17.2 per cent.

VI. Probable Magnitude of Sales

Little incentive is given by the plan to individuals with incomes below $10,000 to increase their holding of E and F bonds. Yet, this is the mass market. Moreover, there would be little scope for the few (500,000) individuals above this level to make additional purchases since the vast bulk of them probably have more than $500 of Government interest apiece (equivalent to about $20,000 in terms of principal) at the present time. Consequently, it is unlikely that a significant amount of additional bonds would be sold by the proposal. Raising the exemption limit above $500 while it might increase sales would change the character of the plan from a limited tax incentive scheme to a general exemption of all Government interest payments.

VII. Effect of the Proposal in Combating Inflation

To be considered as a primary weapon against inflation, the proposal would have to produce an increase in the amount of saving and a decrease in the amount of consumption by individuals. Its prospects in this respect are not very bright. Experience shows that the saving and spending habits of the lower income groups are not sensitive to small changes in interest rates such as the proposal offers. The upper income groups, it is true, are offered a large premium to purchase the bonds but a $500 (or even $1,000) limitation on interest payments enormously reduces the potential market at these levels. Furthermore, it is far more likely that those additional purchases of bonds actually made by the upper income groups will be financed by the sale of other securities including Government securities rather than by any reduction in current expenditures or living standards. Finally, if E and F bonds were converted to a coupon basis the extra billion dollars of cash interest (plus the tax relief on outstanding G bonds) would probably more than offset any slight anti-inflationary effects.

VIII. Relation of the Proposal to Tax Policy

A most important objection to the plan is its partial abandonment of the Government's basic tax policy of opposing exemption of the interest on Government securities.

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