



# Review

**FEDERAL RESERVE BANK OF DALLAS**

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**Tax Reform—**

**A Look at the Treasury's Proposals**

**U.S. Savings Bonds—**

**Program Becomes Net Supplier of Funds**

# A Look at the Treasury's Proposals

By Patrick J. Lawler

Tax reform has been a perennial issue, and this year is no exception. Moreover, prospects for a major overhaul are greater now than in some time. During his campaign, President Carter called the current tax system "a national disgrace" and promised sweeping change. At the same time, the Treasury Department, under former Secretary William E. Simon, was finishing a study, titled *Blueprints for Basic Tax Reform*, that proposes drastic tax revisions. Because of its thoroughness and breadth, this report is a convenient starting place for considering some of the options open to the President and Congress this year.

The Treasury presents two major alternatives. The first features the complete integration of personal and corporate taxes and elimination of most exclusions and deductions. The taxes would be integrated by including corporate earnings in individual income on a per-share basis regardless of what portion of the profits is paid out in dividends. For individuals, the tax base, or net quantity subject to tax, would be further broadened by ending the current exclusions of public transfer payments, such as social security payments and unemployment compensation. The 50-percent capital gains exclusion would also be eliminated, but the purchase price of capital assets would be adjusted for inflation, which would reduce the size of the gains and turn some into losses. Other exclusions and deductions that would be eliminated include medical expenses, charitable contributions, state and local bond interest, and state and local property, sales, and gasoline taxes. For businesses, accelerated depreciation and expensing of intangible drilling costs in the petroleum industry would be ended. These changes would result in a simplified tax code and, since the tax base would be larger, lower tax rates.

The second alternative presented in the Treasury's report is even more radical. The basic concept would be changed from an income to a consumption tax by subtracting all saving from the tax base. This would prevent double taxation of savings (once on saved income when first earned and again on the earnings of the savings) and totally eliminate the most complicated portions of the current tax code. There would be no corporate income taxes nor any capital gains taxes. For private businesses no depreciation need be computed; all capital outlays would be imme-

diately deductible. Consumption would be computed as receipts from all sources, including dividends and loans less all savings. Savings would include net additions to savings accounts, net purchases of common stocks, contributions to pension plans, and, for private businesses, capital goods purchases. The tax would be progressive and the rates adjusted so that the wealthy would not benefit at the expense of the poor.

These proposals encompass, in their many facets, virtually all the major issues facing this year's tax reformers. In this article, three of the basic features of the Treasury's proposals are evaluated on the basis of commonly used criteria. Among the conclusions, integration of corporate and personal income taxes would likely improve the allocation of investment funds, by increasing the probability that the investment activities with the highest before-tax yield would also have the highest after-tax yield. A second Treasury option, adjusting the tax base for inflation, would almost certainly improve the equity of the tax system. On the other hand, replacing the income tax with a consumption tax might easily cause serious transition problems that would outweigh the potential benefits.

## Criteria for evaluation

The criteria by which tax systems should be judged are neither obvious nor universally agreed on. But at least four are commonly used—horizontal equity, vertical equity, efficiency, and simplicity.

*Horizontal equity* means simply that equals should be treated equally. However, it is difficult to determine, in practice, which individuals are equal and whether they are being treated equivalently. If by "equal" is meant having the same level of well-being, then we must concern ourselves with tastes, working conditions, opportunities, and income (or the same consumption if that is the tax base). Since we cannot actually measure the first three, it is easiest to assume that tastes, working conditions, and opportunities are the same and look only at income.

But this is not always appropriate. Persons with the same income may derive very different utility from it. Some may be very ill and need much of their income for medical expenses. Others may have a rela-

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tively large share of leisure time. Some may like their jobs while others do not. It is impossible to evaluate the relative well-being of individuals without a great deal of subjectivity. Income is only one aspect of well-being, but at least it can be measured objectively. Thus, consideration of horizontal equity is essentially limited to comparing the tax burdens of individuals with equal income who may receive it from different sources.

Evaluation on the basis of *vertical equity* assumes that those who earn more are able to pay more. There is wide agreement that the rich should pay at least as great a percentage of their income in taxes as the poor. Exactly how progressive the tax system should be, however, is still a subject of controversy.

*Efficiency* as a major criterion of tax evaluation concerns the generally deleterious effects of taxes on the allocation of resources within the private sector. Taxes not only raise revenue but also affect economic behavior. In an effort to minimize taxes, individuals and firms make choices they would otherwise consider less desirable. In the aggregate, there is no tax saving since the money must be raised one way or another, but the distorted choices remain. Typically, taxes cause resources to be diverted from their most productive uses. This reduces overall production and, hence, real income.

*Simplicity* is actually an aspect of efficiency. A complicated tax results in a great waste in resources for the purpose of keeping records and filing correctly. Currently, half of all taxpayers pay someone else to compute their taxes.

These are the primary criteria for evaluating alternative ideal tax systems. Reform of an existing but flawed system introduces two additional considerations. First, would a proposed change be unfair to people who have made important decisions in the past based on a different set of rules? Second, if reform is only partial, a change that appears to move in the direction of ideal notions of equity or efficiency may actually be counterproductive in combination with remaining imperfections.

These criteria are not easy to apply. Conflicts are unavoidable. Taxing everyone the same amount regardless of their economic situation would be efficient, but not many would consider it equitable. And while society might find it equitable to tax income above a certain level at a 100-percent rate, doing so would be inefficient since those who had been earning more would cut back on their effort and their output would decline.

Furthermore, it is often difficult to determine how well particular criteria are met. With these difficulties

in mind, we examine three of the most important Treasury proposals.

### Consumption tax or income tax?

A widely accepted justification of the income tax is that its levies are, with some imperfections, directly related to the ability to pay them. Those with high incomes can presumably part with larger amounts than those with low incomes without suffering more as a result. There are, however, other ways of apportioning taxes that also have some appeal. One alternative with a long history is that those who benefit most from Government expenditures should pay the most taxes regardless of income. But the distribution of benefits is often difficult to determine, as with national defense spending, and some expenditures are deliberately aimed at changing income distribution.

The consumption tax is based on the somewhat different notion that it is better to tax on the basis of what a taxpayer withdraws from the economy (consumption of economic output) rather than what he contributes to the economy (income from the supply of economic inputs). Thus, income not spent is not taxed. This results in a smaller tax base but, since income and consumption are highly correlated, one that is distributed among taxpayers very similarly.

Indeed, there is little to choose between consumption and income taxes on equity grounds, either horizontal or vertical. The Treasury report contends that an income tax discriminates unfairly against savers *vis-a-vis* spenders, but that conclusion is somewhat arbitrary. The report notes that with an income tax, two taxpayers with the same lifetime resources do not pay the same tax if their consumption patterns differ. If both have the same initial assets and time path of labor earnings, the one who spends his money sooner pays a smaller tax since his investment earnings are smaller. While this "lifetime" view is reasonable, it can be argued, with equal justice, that two taxpayers with the same income in a particular period should not be taxed differently in that period since each faces the same alternatives.

With respect to vertical equity, many have argued against a broad-based national consumption tax because it would be regressive, but this need not be the case. A consumption tax can be just as progressive as an income tax. While state sales taxes are levied on each purchase without regard to whether the purchaser is rich or poor, the type of consumption tax advocated by the Treasury proposals would be computed by the individual once a year, as the income tax currently is. That would make it possible to tax individuals with high consumption levels at steeply progressive tax rates.

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It is on the grounds of economic efficiency that consumption tax proponents, including the Treasury, make their strongest case. Switching to a consumption tax would eliminate a major source of tax-caused distortions. In allocating their after-tax income between consumption and saving, households are currently affected by the fact that saving is less rewarding than it would be without the income tax. If a household can earn, for example, 7 percent interest on its savings and its marginal income tax rate is 20 percent, the after-tax reward for saving will be only 5.6 percent (80 percent of 7 percent). But if the 7 percent is a good indicator of the marginal return to capital, it means that each dollar of additional saving could add \$1.07 to next year's output. The household that bases its decision on 5.6 percent may well save less than it would if it were able to keep all of the 7-percent return. Thus, an optimum amount of saving may not be undertaken in the economy when income saved is taxed the same as income consumed.

The consumption tax would remove this distortion. A decrease of \$100 in consumption this year would reduce taxes by \$20, making it possible to increase savings by a total of \$120. At 7 percent interest it would be worth \$128.40 next year. The household would be able to spend \$107 of that amount and still pay a 20-percent consumption tax of \$21.40. The \$100 reduction in consumption yields a full 7-percent reward with the consumption tax.

The Treasury document argues that the elimination of the consumption-saving distortion would induce increased savings, which would cause lower interest rates and increased investments. This is not necessarily true. Households that save for specific future needs would find those needs could be met with fewer dollars of current saving. Whether aggregate saving would increase or decrease is a question for which economists have found different answers.<sup>1</sup> If switching to a consumption tax turned out to have little effect on savings, it would indicate that this distortion flowing from the present income tax was minimal.

However, institution of the consumption tax proposed by the Treasury could create other distortions.

Not all saving would be exempt. A high proportion of all saving by households, as much as 50 percent, is in the form of direct investment in human capital.<sup>2</sup> A large portion of private education outlays, and some health outlays, fall in this category. Some human capital investment—for instance, income forgone to attend school—would not be taxed, but much of such investment, especially tuition, would be treated like an ordinary consumption expenditure. Thus, while the Treasury's consumption tax would eliminate the distortion between consumption and investment in nonhuman capital, it would not eliminate the distortion between consumption and investment in human capital. In addition, it would introduce a new distortion between investment in human as opposed to nonhuman capital. Whether the net result is an improvement would be hard to decide on the basis of current information.<sup>3</sup>

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It is sometimes argued by critics of the consumption tax that such a tax would aggravate an already existing distortion. Because a consumption tax base would be smaller than an income tax base, the tax rates would have to be higher to collect the same total tax. This, it is argued, decreases the incentive to earn extra money. This is true for those who would spend all of any increased earnings, but for those who would save as much as the national average saving rate, the tax on the extra earnings would total the same as with an income tax. So long as saving is one of the goals of working, work incentives should not be impaired.

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1. Colin Wright, for example, has found that aggregate saving would increase in "Saving and the Rate of Interest," in Arnold C. Harberger and Martin J. Bailey, eds., *The Taxation of Income from Capital*, Brookings Institution Studies of Government Finance (Washington, D.C., 1969), pp. 275-300. Warren E. Weber has found the opposite in "The Effect of Interest Rates on Aggregate Consumption," *American Economic Review* 60 (1970): 591-600.

2. See John W. Kendrick, *The Formation and Stocks of Total Capital*, National Bureau of Economic Research, General Series, no. 100 (New York and London: Columbia University Press, 1976), pp. 90, 167.

3. It depends on the amount of nondepreciable investment in human capital as well as the relative responsiveness of saving to interest rate changes, compared with the extent to which investment funds are shifted between human and nonhuman alternatives in response to a change in their relative rates of return.

The consumption tax also merits mixed ratings on simplicity. As the Treasury study points out, this tax would avoid many of the current complications in our tax code. Depreciation, capital gains, corporate taxation would all become irrelevant. Income from capital would not have to be measured—only actual cash receipts, which are easier to keep a record of and are less open to varying interpretation.

On the other hand, a consumption tax has serious weaknesses of its own. One involves the purchase of durable consumer goods, such as houses, automobiles, and major home appliances. If the entire tax associated with the purchase of these items is paid in the year they are purchased, the tax will be highest when households may be least able to afford it. Furthermore, extensive provision for tax averaging would be necessary since a house purchase, for example, would put almost anyone into one of the highest tax brackets.

To alleviate this problem, the Treasury develops a complicated procedure to allow individuals to spread out their tax payments. At their option, taxpayers could deposit some of their savings in what the Treasury calls “nonqualified” accounts. Tax would be paid on these deposits as though they were used for consumption purposes. Later, money accumulated over several years could be withdrawn, tax-free, and used toward the purchase of a durable good. Additional funds for a durable purchase could be borrowed. Normally, proceeds from borrowing would be taxable and repayments deductible. But money borrowed and deposited in a nonqualified account would be ignored for tax purposes.

While these options would help to avoid the possibility of taxes exceeding income in some years, the consumption tax has disadvantages. For one, it introduces considerable complexity since each bank account or brokerage account would need to be classified as “qualified” or “nonqualified.” This choice of accounts would do much to maintain the importance of planning for the purpose of minimizing tax. For another, any capital gain on a house purchased this way would not be taxed, and a loss would not reduce the tax. This violates the notion of vertical equity.

An even greater problem would be caused by the transition from the income tax to a consumption-based tax. An immediate switch would be unfair to retirees who are financing current expenses by drawing down savings balances. Because they have already paid income tax on the earnings that were saved to create their assets, it would be unreasonable to charge them an even heavier consumption tax on the same money when it is spent. An alternative would be to let spending from the principal or earn-

ings of all currently existing assets be spent tax-free. However, this alternative seems unreasonably generous to those living on interest and dividends since it would eliminate their taxes forever.

The Treasury proposes to phase in the new tax over a ten-year period, requiring the relatively well-off to compute their tax both ways and pay the higher amount. This would clearly add to tax complexity for a fairly long period and could overwhelm any simplifications.

The consumption tax may appeal to some on equity grounds and might ultimately reduce tax-caused distortions and resources devoted to tax planning and tax compliance. But the overall gain in economic efficiency is not certain, and transition problems are considerable.

#### **Integration of corporate and personal income taxes**

If a consumption tax is adopted, there would be no need to compute corporate income for tax purposes. However, in the likely event that income remains the tax base, the current tax treatment of corporate income deserves scrutiny. The Treasury recommendation is for radical change—full integration of personal and corporate taxes. Tax payments would continue to be made by corporations, but they would be treated as withholding for individual taxpayers. Taxpayers would treat income of corporations in which they held shares as though it were partnership income. Thus, corporate income would be taxable to shareholders whether distributed as dividends or retained by the corporation. This change offers significant benefits in equity and economic efficiency.

Perhaps the most common complaint regarding the corporate tax is that it causes “double taxation of dividends.” Income is taxed first when earned at the corporate level and then at the individual level when it is paid out as dividends. Retained earnings are also taxed twice—once when earned by corporations and again as capital gains when shares are sold. Since income from noncorporate equity capital and income from labor are taxed only once, those whose income is largely derived from corporate shares are treated inequitably compared with taxpayers whose income is the same amount but is derived from other sources.<sup>4</sup> Integration would eliminate double taxation of corporate earnings.

4. Since current shareholders have in most cases purchased their shares at prices that reflected the effects of the tax, most of the inequity was suffered by those who held shares when the tax was inaugurated and when it was increased.

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Another weakness of the corporate tax is its failure to discriminate with regard to the differing income levels of shareholders. Rich and poor alike are subject to a 48-percent marginal tax rate on the earnings of their corporate shares. Integration would tax corporate income at rates appropriate to the individual shareholders. Those in the 70-percent bracket would pay more tax; those in the 18-percent bracket would pay less.

The corporate income tax also causes distortions in economic decisionmaking, and integration would almost certainly improve the efficiency of our economy. Because corporate income is taxed more heavily than noncorporate income, investment spending is biased away from corporate capital in favor of noncorporate capital. Corporate investments with a higher pretax return are rejected in favor of other investments with lower pretax yields. Thus, investment capital is not directed to its most productive uses. Integration would remove this distortion.

Another distortion results because interest payments are deductible from corporate income. The current system reduces the cost of debt financing relative to equity financing and encourages firms to operate with higher debt-equity ratios than they otherwise would. Integration would remove this advantage of debt. Whether a net benefit results would depend on what changes are made in capital gains taxation. The current preferential capital gains treatment leads investors to favor stocks over bonds; integration with no change in capital gains taxation might merely replace the debt bias with an equity bias. The Treasury study recommends treating gains as ordinary income, which in conjunction with integration would virtually eliminate both sources of bias.

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A third distortion might also be purged—again depending on possible changes in capital gains taxation. Since dividends are taxed more heavily than capital gains, firms currently have an incentive to minimize dividends. Integration would require investors to pay tax on all corporate income whether distributed or not, so this incentive would vanish. In

fact, with the current capital gains law, there would be an incentive for firms to pay out all earnings. Retained earnings increase the value of the stock, which creates future capital gains tax liability. So, retained earnings would still be doubly taxed. If corporations pay out all income in dividends, this double taxation could be avoided.

To prevent this problem, the Treasury proposes computing capital gains for equities as the difference between the sale price and the sum of the purchase price and all retained earnings during the holding period. Then earnings would presumably be retained only when the costs to firms of raising money in capital markets exceeded the improved returns, if any, that investors might anticipate by investing their money elsewhere. The number of conglomerate mergers would almost certainly decline.

If the capital gains law is not changed, investors would have the incentive to demand 100-percent payout of earnings to avoid double taxation. Firms would then have to go to capital markets for all new financing, even though much of it might come from current investors. Significant resources would be wasted to avoid capital gains taxes. If annual adjustments in the purchase price to include retained earnings are allowed, however, computing and administering the capital gains tax would become more complicated. The tax liability would depend not only on the sale and purchase prices but also on the earnings of the shares in each year the stock was held.

Another problem is caused by the treatment of shares bought and sold in the middle of a year. How should earnings and dividends be apportioned among partial-year shareholders? If they are simply assigned in proportion to the length of the holding period, short-term traders would not be able to determine if they have made a profit when they sell.

Perhaps the biggest drawback of integration is the revenue loss it would probably cause. Revenues would be reduced because dividend income would be taxed only once, the size of capital gains would be reduced, and individuals pay taxes at lower marginal rates, on average, than corporations. The projected loss would be smaller if pension funds and nonprofit organizations that own a large share of corporate stock were forced to pay tax on earnings of their shares. The Treasury proposal would, in fact, tax pension fund earnings, although it would exempt employee contributions.

Regardless, some revenue will be lost, and a full evaluation of integration requires knowledge of how the revenue would be replaced. If it would be replaced by an increase in income tax rates, increased distor-

tion in choices between leisure and working hours may result. Furthermore, since the total tax on corporate income would be reduced, the value of corporate shares would rise, giving a windfall benefit to current shareholders and a possible loss to holders of alternative investments.

In sum, there are a number of possible problems associated with putting full integration into practice, but the result would be a more equitable distribution of tax burdens, both horizontally and vertically. Furthermore, capital would be distributed more effectively, both between corporate and noncorporate uses and within the corporate sector, so that investment would be channeled to the areas of greatest productivity.

### Adjusting the tax base for inflation

Inflation affects the current tax system by distorting the tax base and by increasing effective tax rates. The latter results as inflation pushes individuals into higher tax brackets. This could be avoided by adjusting personal exemptions, standard deductions, and the boundaries of the rate brackets for inflation. An alternative solution is to cut taxes periodically. This procedure has obvious political attractiveness and has been used in recent years.

The distortions in the tax base are a more nettlesome problem. There are three major tax base distortions. First, increases in asset values caused by inflation are taxed as capital gains even though no real increase in value has occurred. Second, depreciation allowances based on historical costs understate the loss in value of physical assets in an inflationary period. Third, borrowers pay less tax and lenders more as a result of the inflation premiums added to interest rates.

**Capital gains.** Capital gains are currently computed on the basis of actual buying and selling prices. To the extent that the price has increased because of general price inflation, a seller's gain is more apparent than real. Yet the tax is just as large. Partly on this basis, current law allows the seller to exclude from taxable income 50 percent of the gain. This corrects the problem and results in an accurate measure of income only in situations where the measured gain is caused half by inflation and half by a real gain in value.

However, individual situations will rarely be half and half. In other cases the current procedure is inequitable and inefficient. It undertaxes individuals with gains more than twice as large as those stemming from inflation and overtaxes those with apparent gains that only reflect general price change.

Taxation of all nominal capital gains discourages investment in "growth" industries during periods of rapid inflation by lowering their after-tax return. When inflation is slower, the 50-percent exclusion more than compensates for inflation and provides an incentive to invest more heavily in assets whose prospective return is largely in capital gains rather than in dividends or interest. This distortion has the effect of channeling investment funds into relatively unproductive areas.

The Treasury proposes to compute gains by subtracting the inflation-adjusted purchase price from the sale price. The resulting gains would be true income, not a mixture of income and inflation distortions, as is now the case. The 50-percent exclusion would be eliminated. These proposals would solve the current problems but would complicate tax compliance. The computation of capital gains on common stocks would require adjusting the purchase price for inflation and, if the tax integration proposals are accepted, adjusting the retained earnings for inflation for each year the stock is held. Nevertheless, at current inflation rates, the benefits might well outweigh the costs.

**Depreciation.** Deductions for capital usage are currently allowed on the basis of historical cost. The resulting allowable deductions do not reflect true usage when the historical cost on which they are based is far below current asset costs. Taxpayers with particularly long-lived assets are affected the most. Accelerated depreciation is often justified as an offset to this problem, but, like the capital gains exclusion, the rapid write-offs give excess benefits to some and inadequate benefits to others. This is a source of inequity in the tax structure.

The current depreciation procedures also distort economic decisions. They encourage investment when future inflation is expected to be slow and discourage it when rapid inflation is anticipated. They also provide an incentive to invest in relatively short-lived equipment since the longer the period over which the deductions for a machine are taken, the more inflation lessens their value.

The Treasury recommends that depreciation be computed as a percentage of historical cost, as is the current practice, but adjusted for changes in the general purchasing power of money. To prevent overcompensation for inflation, the Treasury recommends simultaneously eliminating all accelerated depreciation alternatives. This improvement would also add some complexity. The depreciation computations would require adjusting the purchase price of each item. But like the capital gains adjustment, it is

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desirable if inflation is rapid enough. Otherwise, it would be a lot of work with very little return.

**Borrowing and lending.** The Treasury recommends no changes in taxation of borrowers and lenders for income tax purposes. But inflation causes a tax base distortion for them as well. An investor in bonds is in much the same position as an investor in stocks. Each receives some income while holding the assets—interest to the bondholder and dividends to the stockholder. And each may sell them for a price different than he paid for them. The Treasury would have the stockholder pay tax on only the inflation-adjusted capital gain but would require the bondholder to compute his gain on a nominal basis. Adjusting for inflation, the bondholder generally suffers a loss on the principal, which the Treasury would not let him deduct. Similarly, the debtor makes a gain on the principal after deducting for inflation.

The Treasury argues that this is not inequitable to lenders because the lender can demand and get an interest rate high enough to offset both the inflation and its tax consequences. For example, suppose both borrower and lender of a one-year debt are in a 50-percent tax bracket and agree on a "real" interest rate of 5 percent. If no inflation is expected, they set the nominal interest rate at 5 percent. After taxes the lender receives 2.5 percent, and the borrower loses 2.5 percent. Now suppose each expects 5-percent inflation. They can now set the nominal interest rate at 15 percent and come out as well as before. The lender receives 15 percent but pays 7.5 percent in taxes. In addition, his principal loses 5 percent of its value because of inflation so he nets 2.5 percent, the same as before. The borrower's position is just the reverse; he pays 15 percent but lowers his taxes by 7.5 percent. The principal he repays is worth 5 percent less than what he borrowed so the net cost remains 2.5 percent. Therefore, no tax change seems necessary.

However, different results occur when the borrower and lender have different marginal tax rates or do not correctly anticipate inflation. If the lender has a 50-percent tax rate and the borrower a 40-percent rate, the lender would require a 15-percent interest rate but the borrower would be willing to pay only 12.5 percent. In general, borrowers in low tax brackets borrow less and those in high brackets borrow more, while the reverse is true for lenders. Funds are not transferred from where they are most easily relinquished to where they will have the highest return—producing another source of economic inefficiency.

In addition, errors in anticipations affect the fairness of the tax. Reconsider the situation where both

agree on 5 percent interest and neither anticipates any inflation. If a 5-percent inflation occurs, the borrower has received a windfall that is not taxed and the debtor has incurred a loss, in real terms, that he cannot deduct.

The solution is straightforward though. It is only necessary to adjust the principal for inflation, tax the resulting gain to the borrower, and let the lender deduct the loss. Existing debts should not be included since the interest rates were determined under different tax rules. The transition would be long since some existing debt will not mature for another 40 years or more, but it would not be complicated.

The change would have only minor effects on the Federal budget. In the aggregate, the newly allowed losses for private-sector lenders would equal the taxable gains for private borrowers. The marginal tax rates of borrowers and lenders are probably not too dissimilar, on average. The Treasury's own borrowing would also be affected; it would be able to borrow at lower interest rates. But part of its saving would be offset by lower tax receipts from Government debtholders.

### Summary and conclusions

Tax reform appears to be an important issue again this year. The proposals in the Treasury blueprint are among the boldest and most sweeping of those that will receive public scrutiny. Of those changes considered here, a switch from an income to a consumption base for computing personal taxes fares least well as measured against the four criteria used. Perhaps if we could start all over and design a new tax system in a new society, a consumption tax would be better. But the transition problems seem overwhelming.

On the other hand, integration of corporate and personal taxes and adjusting the tax base for inflation have advantages great enough to warrant continued consideration. A key problem with integration is that it would reduce tax revenues. How those revenues would be recouped is crucial to any final decision on merging the two income taxes.

Adjusting the tax base for inflation is clearly more desirable the higher future inflation is expected to be. At current inflation rates, the Treasury proposals offer clear advantages with little administrative and compliance cost.



## Program Becomes Net Supplier of Funds

By Mary G. Grandstaff

The U.S. savings bonds program has provided a convenient and safe investment outlet for small savers throughout its 36-year life span. Although most people are well aware of the program as a tool for wartime financing or as a systematic savings plan for small savers, many may be unaware of the still significant size of the program or its continuing important role in financing the Federal Government.

The volume of savings bonds outstanding rose to almost \$72 billion—or more than a sixth of the privately held portion of the public debt—at the end of 1976. Sales of the bonds increased to \$7.6 billion in 1976, while redemptions (including accrued interest) totaled \$6.8 billion.

The savings bonds program originally offered yields that were well above those available on most alternative investments for individuals. Subsequently, the number of investment options available to these investors, as well as the yields on the invest-

ments, has risen sharply. However, savings bonds have two major advantages over many of the higher-yielding alternative investments—safety of principal and a guaranteed yield at maturity. Many owners of savings bonds are those least able to withstand a speculative loss. To these investors, savings bonds remain a relatively attractive investment.

The wartime financing needs are long past. But the Treasury continues to promote sales of savings bonds as vigorously as possible because of their significant contribution to debt management.

### Characteristics of program

The current U.S. savings bonds program was instituted in 1941 as an aid in financing World War II and was designed primarily to siphon off a part of the war-induced surge in personal income, thereby moderating inflationary pressures. The roots can be traced as far back, however, as the Postal Savings Act of 1910. The program has been revised and expanded in the postwar period, emphasizing individual savings and wider ownership of the public debt. To achieve those goals, the savings bonds program seeks to attract small savings of a large number of individuals through the incentives of safety, liquidity, and convenience.

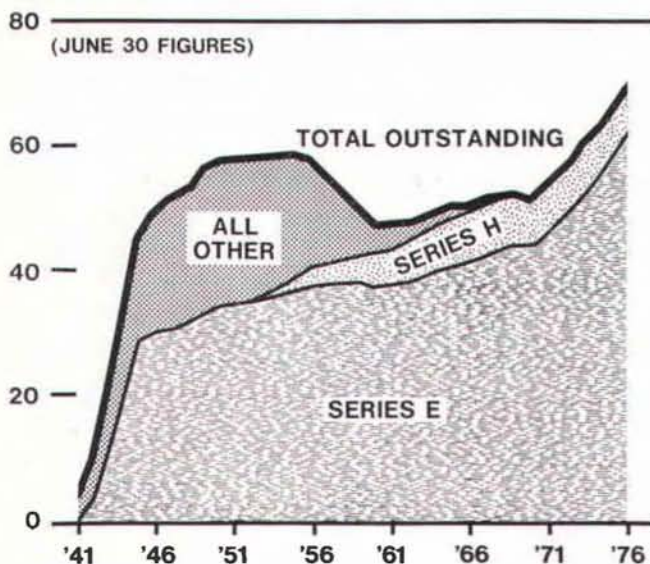
Various types of savings bonds have been offered. Now, however, only two types—Series E and Series H—are issued, and only \$18 million of other types of savings bonds remains outstanding.

Series E bonds, which represent almost 89 percent of total savings bonds outstanding, are accrual bonds—yielding income only when cashed—and may be purchased and redeemed at most banks and thrift institutions. Since the beginning of the program, most purchases of these bonds have been made through payroll savings plans in denominations as low as \$25.

Series E bonds originally yielded 2.9 percent when held to maturity at ten years. After several upward adjustments in response to generally rising interest rates, these bonds now yield 6 percent when held to maturity at five years. The owner of E bonds also has the option of redeeming his bonds, at a lower interest yield, anytime after the first two months following the issue date.

Volume of U.S. savings bonds resumes climb

BILLION DOLLARS



SOURCE: U.S. Treasury Department.

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For the individual saver, E bonds are similar to regular savings accounts at financial institutions. They represent a safe, standardized investment that is easily and continuously available at a large number of sales outlets and can be readily converted to cash without risk of loss (although early redemption will result in a lower yield). But as is true of all fixed-value investments, savings bonds are subject to losses in purchasing power as a result of inflation.

Series H bonds, which account for approximately 11 percent of total savings bonds outstanding, yield income payable semiannually. First issued in 1952, these bonds are sold at par in various denominations beginning at \$500. Although H bonds are issued and redeemed only by Federal Reserve banks or branches and the Bureau of the Public Debt in Washington, most commercial banks and other financial institutions will accept applications for H bonds and forward them to the district Federal Reserve office.

Interest on Series H bonds, paid semiannually, at present averages 6 percent for bonds held to maturity at ten years. The owner may redeem his H bond at par anytime after the first six months following the issue date. The interest is 5.0 percent for the first year, 5.8 percent for the next four years, and 6.5 percent for the second five years.

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*U.S. savings bonds possess three important features that make them unique among Treasury securities. Savings bonds are sold directly to individuals, the Treasury does not have close control over their total amount, and the bonds are non-marketable.*

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The interest on both E and H bonds is subject to Federal income taxes but is exempt from all state and local income taxes. Interest on Series E bonds is reportable for Federal income tax purposes as it accrues, or the reporting may be deferred until the interest has actually been received—through redemption or at final maturity. The final maturity can be quite long. All matured E (as well as H) bonds have been granted one or more ten-year extensions and are earning interest at the current rate.

The tax deferral feature has made E bonds particularly attractive as a savings instrument for retirement. Some of this appeal undoubtedly has

been negated in recent years for individuals who qualify to set up Individual Retirement Accounts under the Employee Retirement Income Security Act of 1974. Nevertheless, tax deferral of interest on Series E bonds may still prove attractive to many individuals—those who do not qualify for Individual Retirement Accounts or who wish to supplement other plans.

U.S. savings bonds possess three important features that make them unique among Treasury securities. Savings bonds are sold directly to individuals, the Treasury does not have close control over their total amount, and the bonds are nonmarketable.

Savings bonds are the only U.S. Government securities that are designed primarily for individuals. A \$10,000 limit on annual purchases makes them relatively unattractive to most financial institutions, and commercial banks continue to be prohibited from purchasing the bonds for their own account. But holdings of savings bonds represent more than 72 percent of the total public debt holdings of individuals.

The savings bonds debt is the only segment of the public debt that is not under the close direct control of the Treasury. For other Government securities, the Treasury normally decides, in advance of issue, the total amount to be sold. In contrast, the Treasury stands ready to sell or redeem savings bonds at the option of investors—subject only to the \$10,000 limit on annual purchases of E bonds or H bonds.

#### **Pattern of sales and redemptions**

The U.S. savings bonds program reached the height of its popularity during the war years, when funds from the bonds accounted for about a fifth of all funds raised for financing the war. Aided by patriotic enthusiasm, shortages of consumer goods, and an attractive yield (the highest rate available on any Government security at that time), the volume of savings bonds outstanding rose from \$4 billion at mid-1941 to \$46 billion at mid-1945.

After the war ended, individuals began to acquire goods that had been in short supply. Purchases of these goods consumed a greater share of current income, and many individuals financed such purchases by redeeming their small-denomination savings bonds. But sales of larger-denomination bonds (those with face values of \$200 or more) continued to grow and combined with accrued interest on outstanding bonds to increase the total savings bonds debt until 1950—although at a much slower pace than in the war years.

The volume of savings bonds outstanding was fairly stable from 1950 through 1955. After the out-

break of the Korean War in 1950 and with the Treasury-Federal Reserve accord in 1951, yields on competitive investments rose, and savings bonds lost much of their attractiveness.

Beginning in fiscal 1951, net redemptions slightly exceeded net sales continuously. However, net accrued interest on outstanding bonds remained sufficient to keep the total savings bonds debt fairly stable until 1956. That year, cash sales fell rapidly as sales of larger-denomination bonds began to drop dramatically, and cash redemptions rose sharply.

A major portion of the increase in redemptions was centered in Series F, G, J, and K bonds, which had been purchased by nonbank financial institutions. These institutions were, on the whole, more sensitive to rising interest rates on alternative investments than were individuals holding Series E bonds.

Sharply rising market interest rates resulted in the continued erosion in the attractiveness of savings bonds. Despite several upward adjustments in the yield on savings bonds beginning in 1957, these adjustments lagged the rise of market yields. The net cash drain on the Treasury as a result of net redemptions of savings bonds (including accrued interest) rose to about \$4.25 billion in fiscal 1960.

The volume of savings bonds outstanding rose only slightly between 1961 and 1971, with all the increase accounted for by accrued interest on outstanding Series E bonds. Total redemptions exceeded total sales in each of the 11 fiscal years.

Concern about the continued net redemptions of savings bonds led to increased efforts to promote sales. The yield on savings bonds was raised to 5.0 percent in mid-1969, to 5.5 percent in mid-1970, and to 6.0 percent (the current rate) at the end of 1973. These actions allowed savings bonds once again to provide yields roughly comparable with those on regular savings accounts at commercial banks and savings and loan associations. The higher interest rates and increased promotional activities have boosted sales and ended the cash drain on the Treasury. Except in 1974—when yields on many alternative investments reached record levels—sales of savings bonds have exceeded redemptions in every fiscal year since 1971.

The major portion of sales of Series E bonds are made through payroll savings plans. About 9.5 million individuals are currently enrolled in the payroll savings plans offered by more than 40,000 companies and state and local governments and about 3,000 Federal departments and agencies. The U.S. Industrial Payroll Savings Committee, formed in

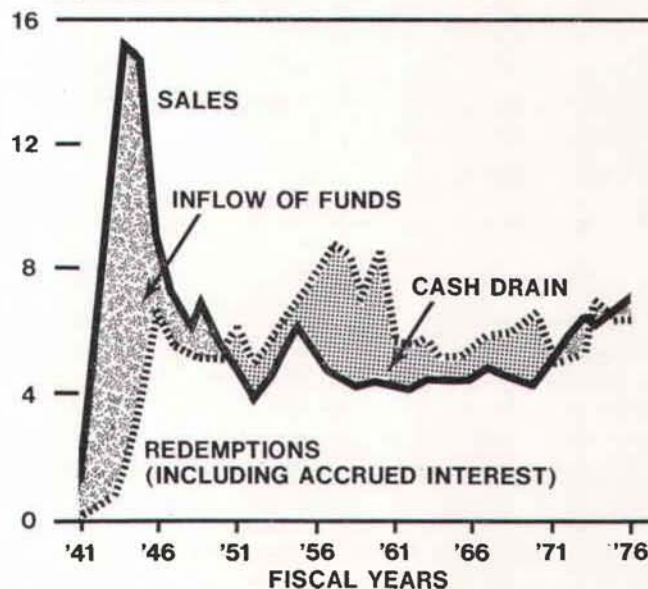
1963, is generally credited with being the principal force in raising the volume of sales of smaller E bonds—those in denominations of \$25 to \$200—to almost twice the level of 1962.

Of the people involved in the promotion of savings bonds sales, some 640,000, or about 97 percent, are volunteers. Moreover, during the 15-month period ended September 1976, the advertising media alone contributed about \$75 million in time, services, and space—including more than 25,000 newspaper advertisements and 240,000 lines in national magazines. Largely as a result of these efforts, the Treasury's total public-debt servicing costs in fiscal 1976 were nearly 2 cents less for each dollar raised through the sale of savings bonds than for each dollar raised in capital markets.

The Federal Government's debt servicing costs for the savings bonds program include a reimbursement fee paid to financial institutions for redeeming savings bonds. This fee averages about 12 cents for each bond redeemed. The costs of issuing savings bonds are absorbed by institutions and employers.

### U.S. savings bonds regain role of net supplier of funds

BILLION DOLLARS



SOURCE: U.S. Treasury Department.

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### Importance to debt management

Since its inception, the U.S. savings bonds program has been an important instrument of debt management. The program played a key role in providing funds for financing World War II. It also lessened the inflationary impact of financing the war by diverting consumer purchasing power from scarce consumer goods to Government use in procuring implements of war.

While attrition from the excess of redemptions over sales was a net drain on Treasury funds from fiscal 1951 through 1971, savings bonds redemptions did not present the difficulties of a large volume of debt maturing at one time. The cash drain was less than \$2 billion in most of the years, and presumably this could have been avoided with timely adjustments of interest rates on these bonds. In addition, the cash drain was generally spread out during each year.

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*On the basis of past experience, the Treasury estimates the average life of savings bonds purchased in 1976 at approximately six years—or more than twice the average for the marketable debt.*

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The fact that Series E savings bonds are sold at discount with interest accruing until redemption, rather than being paid currently, has aided in moderating the cash drain on the Treasury in the past. In every fiscal year since 1941, annual interest accruals have exceeded payments of accrued interest on redeemed bonds. Nevertheless, the practice of allowing interest to accrue on E bonds increases the possibilities of larger cash drains in the future. By the end of fiscal 1976, accrued interest accounted for more than a third of the almost \$70 billion of savings bonds outstanding. The payment of accrued interest when bonds are redeemed will push total redemptions to higher levels and necessitate a larger volume of sales to prevent cash drains in the future.

Savings bonds represent a relatively long-term debt instrument. In the past decade, the average maturity of the privately held marketable public debt declined more than half, from about 5 to about 2½ years. Savings bonds may be redeemed, at lower interest levels, shortly after issue but holders generally have retained their bonds for fairly lengthy periods. On the basis of past experience, the Treasury estimates the average life of savings bonds purchased in 1976 at approximately six years—or more than twice the average for the marketable debt.

The longer the life of the debt, the less often the debt must be refunded. To the extent that the Treasury is able to lengthen the maturity of the public debt—and thus reduce the number of times it has to enter the market each year—it eases its refunding problems since it can be more selective in timing refinancings to take advantage of more favorable market conditions. In addition, fewer refundings by the Treasury also contribute to a smoother flow of corporate and municipal financing in capital markets.

A very real benefit accruing from the savings bonds program has been a reduction in the overall cost of servicing the Federal debt. As a result of the longer maturity and considerable donations of services and materials, it is estimated by the Treasury that its total costs of funding the savings bonds debt last year were approximately 25 percent less than the average costs of funding a comparable amount of privately held marketable public debt. The amount of savings thus effected is significant. On average, savings bonds accounted for about 18 percent of the privately held public debt in 1976.

Savings bonds probably will remain an important part of debt management as long as the Treasury holds to the objective of directly attracting the savings of many individuals and offers rates competitive with rates on similar alternative investments. Indicating this is its intent, the Treasury continues to press for removal of the 6-percent rate ceiling on savings bonds so it can react quickly to changing financial and economic conditions and avoid the possibility of future cash drains because of savings bonds redemptions.

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### **New par banks**

Texas State Bank, Abilene, Texas, a newly organized insured nonmember bank located in the territory served by the Head Office of the Federal Reserve Bank of Dallas, opened for business August 11, 1977, remitting at par. The officers are: Oliver Howard, Chairman of the Board (Inactive); Derwood Langston, President; James Rose, Vice President and Cashier; Hollyce McChaw, Assistant Cashier; and Lou Dugan, Assistant Cashier.

Tanglewood Commerce Bank, Houston, Texas, a newly organized insured nonmember bank located in the territory served by the Houston Branch of the Federal Reserve Bank of Dallas, opened for business August 15, 1977, remitting at par. The officers are: Donald L. Neil, Chairman of the Board and Chief Executive Officer; David H. Smith, President; and Linda K. Flournoy, Vice President and Cashier.

Lott State Bank, Lott, Texas, an insured nonmember bank located in the territory served by the Head Office of the Federal Reserve Bank of Dallas, began remitting at par August 15, 1977. The officers are: Turner E. Hubby, III, Chairman of the Board; Dixie Butcher, President; D. P. Shore, Vice President (Inactive); Kenneth Shivers, Vice President; Betty Sudduth, Cashier; Bonnie Cooper, Assistant Cashier; and Beatrice Arnold, Assistant Cashier.

Texline State Bank, Texline, Texas, a newly organized insured nonmember bank located in the territory served by the Head Office of the Federal Reserve Bank of Dallas, opened for business August 22, 1977, remitting at par. The officers are: Rex E. Reeves, Jr., President; Ernest D. Sheets, Vice President; and Anna Marie Osborn, Cashier.

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