T-1702

REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

The Congress Should Consider Repealing The 4-1/4-Percent Interest Rate Limitation On Long-Term Public Debt

Department of the Treasury

The U.S. Treasury has been generally prohibited from selling long-term bonds with interest rates over 4-1/4 percent since World War I. In recent years, this limitation has prevented the Treasury from selling a large volume of long-term bonds.

GAO analyzed the history and economic impact of the 4-1/4-percent limitation and concluded that the limitation no longer serves its original purpose of reducing Federal borrowing costs and may have increased those costs.

The Congress should consider either repealing the limitation immediately or phasing it out through annual redefinition of maturities exempt from the ceiling or through annual increases in the dollar volume of securities that may be floated without regard to the ceiling.

OPA-76-26

APRIL 16, 1976

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114802

To the President of the Senate and the
Speaker of the House of Representatives

The 4-1/4-percent interest limitation on long-term Treasury debt constrains Government borrowing operations because it prevents the Federal Government from financing deficit expenditures or refinancing its outstanding maturing debt with issues whose maturity exceeds 7 years. Market yields are expected to exceed 4-1/4 percent for the foreseeable future. In addition, Federal deficits of the last 2 years have reached unprecedented levels. The inability to at least partially finance these deficits with long-term debt means that the Federal Government will become an increasingly active participant, and a potentially disruptive influence, in private capital markets and in the short segment of the capital market. Because of the magnitude of this problem, we made this review to provide information to the Congress concerning the advantages and disadvantages of the 4-1/4-percent interest rate limitation.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Secretary of the Treasury; the Chairman of the Council of Economic Advisors; and the Director, Office of Management and Budget.

Elmer B. Staats

Comptroller General
of the United States

Contents

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE CONGRESS SHOULD CONSIDER REPEALING THE 4-1/4-PERCENT INTEREST RATE LIMITATION ON LONG-TERM PUBLIC DEBT
Department of the Treasury

D I G E S T

The 4-1/4-percent limitation on interest that can be paid on long-term public debt hampers Federal Government borrowing operations. It prevents the Government from financing deficit expenditures or refinancing its outstanding maturing debt with issues that have maturities exceeding 7 years.

As long as outstanding long-term securities continue to yield more than 4-1/4 percent, the Treasury cannot float long-term debt in its financing and refinancing operations.

The Federal deficit was $72.5 billion during 1975. According to the Wharton Annual and Industry Forecasting Model, the deficit is expected to be approximately $69.0 billion in 1976. The Treasury's inability to at least partially finance these deficits with long-term debt means that the Federal Government will become an increasingly active participant, and a potentially disruptive influence, in private capital markets.

The 4-1/4-percent interest limitation was established during World War I, in 1917-1918. (See ch. 1.) In those days, bonds were sold in an atmosphere of national crisis. Availability of bonds in small denominations insured a sellout of issues at yields below those then prevailing in the market. The U.S. is not now experiencing a national emergency, and suppliers of long-term funds to the capital markets today are very responsive to the rate of interest.

Clearly, the 4-1/4-percent limitation was imposed in special circumstances that no longer prevail. The limitation was set at a 0.25 percent discount from yields <u>then</u> prevailing in the market. Current and foreseeable market yields are considerably higher than 4-1/4 percent.

Has the interest rate limitation benefited or hampered Treasury borrowing operations and the credit markets in which the Treasury borrows funds? The limitation may currently have economic effects not foreseen by the originators of the legislation that are beneficial, thus tending to support its retention. By the same token, it may have economic effects that are harmful.

The following three economic questions are associated with the 4-1/4-percent interest limitation:

--What effect has the limitation had on the average maturity of public debt outstanding?

--What are the implications of the limitation for the management of the public debt?

--Does the limitation presently distort credit markets? Would removing the ceiling have any unfavorable implications for the allocation of credit in money and capital markets?

GAO reached the following conclusions regarding these issues:

--The 4-1/4-percent interest limitation and the exhaustion of the $10 billion exclusion encourage a shortening of the maturity of the national debt. This shortening tendency may, in turn, place the Treasury (1) in a more vulnerable position with respect to its borrowing operations and (2) in the position of being a potentially destabilizing influence on money and capital markets.

--There are three basic philosophies regarding what the objectives of debt management ought to be: avoiding timing disruptions through more systematized securities flotations, fostering the stabilization of aggregate economic activity, and minimizing interest costs. Given contemporary and foreseeable levels of interest rates, achieving any of these objectives will not be possible as long as the 4-1/4-percent interest limitation remains in effect.

--A theoretical basis and some supporting practical experience indicate that the limitation has at times distorted the term structure of interest rates and raised Government and private sector borrowing costs. On the other hand, relevant evidence suggests that repealing the limitation would not cause much distortion in the term structure of interest rates and, hence, would not affect the relative costs of borrowing in various maturity sectors. At best, the ceiling is neutral in its effects on relative costs of borrowing in credit markets. At worst, it may have unfavorable costs effects.

The Congress should consider immediately repealing the 4-1/4-percent interest limitation. Alternatives which would have essentially the same long-term effects are systematically phasing out the limitation through

--annual redefinition of the maximum maturity of securities whose flotation is subject to the ceiling and/or

--annual increases in the dollar volume of long-term securities which may be floated without regard to the ceiling.

The Treasury Department agrees with the conclusions and recommendations of this report. (See app. I.)

CHAPTER 1

BACKGROUND

The 4-1/4-percent interest limitation on long-term public debt constrains Federal Government borrowing operations because it prevents the Government from financing deficit expenditures or refinancing its outstanding maturing debt with issues that have maturities exceeding 7 years. As long as market yields on outstanding long-term securities continue to exceed 4-1/4 percent, the Treasury cannot float long-term debt in its financing and refinancing operations. The Federal deficit was $72.5 billion during 1975 and, according to the Wharton Annual and Industry Forecasting Model, will be approximately $69.0 billion during 1976. The inability to at least partially finance these deficits with long-term debt means that the Federal Government will become an increasingly active participant, and a potentially disruptive influence, in private capital markets. The greater the reliance upon short-term debt, the more often the Government will have to enter the market to refinance its debt and, therefore, the more often it will actively compete for the available supply of loanable funds in private capital markets. Because of the increasing magnitude of this problem, we made this study to provide information to the Congress concerning the advantages and disadvantages of the 4-1/4-percent interest rate limitation.

The Second Liberty Bond Act of September 24, 1917 (40 Stat. 288), provided for a maximum 4-percent interest rate on long-term bond flotations. It was amended by the Third Liberty Bond Act of April 4, 1918 (40 Stat. 502), which provided the current 4-1/4-percent limitation (31 U.S.C. 752). Since that time, the Liberty Bond Acts have been modified three times:

--On June 30, 1967, the maximum maturity of notes excluded from the 4-1/4-percent interest limitation was extended from 5 to 7 years (81 Stat. 99, 31 U.S.C. 753(a)).

--On March 17, 1971, $10 billion worth of long-term bonds were authorized for issuance without regard to the ceiling (85 Stat. 5, 31 U.S.C. 752)(this exclusion has since been virtually exhausted).

--On July 1, 1973, all issues sold to the Federal Reserve and to Government accounts were exempted from the ceiling (87 Stat. 134, 31 U.S.C. 752).

The rationale for imposing the ceiling was reasonably clear. In 1917, the costs of World War 1 were producing deficits of unprecedented size. The Treasury had to request legislation each time it wished to fund these deficit expenditures. Financing during this period was carried out systematically--interim financing was obtained by issuing short-term certificates of indebtedness and funding by selling long-term Liberty Bonds. In selling its short-term instruments, the Treasury wanted to provide banks with advance information regarding financing requirements and to finance deficit expenditures as systematically as possible. Liberty Bonds, on the other hand, were sold through massive advertising campaigns appealing to the patriotism of all Americans.

Circumstances surrounding the Third Liberty Loan flotation, described in the 1918 Annual Report of the Secretary of the Treasury, illustrate the rationale for the 4-1/4-percent interest limitation:

> "With the bonds of previous loans [First and Second Liberty Loans] selling below par and industrial and other securities yielding a return much in excess of the interest rate on government bonds, the question of the rate of interest on new bonds became acute. It was the general banking opinion that the rate should be 4-1/2 percent, and few believed that it would be possible to sell the necessary large amount of bonds at a lesser rate. The Treasury, on the other hand, stood firm in the belief that the rate of interest would not of itself maintain Liberty Bonds at par in the financial markets; that the price of Liberty Bonds, even though quoted at less than par on the exchanges, would not deter the American people from buying at par the same bonds when offered by their government to secure the necessary funds to carry on the war; that the patriotism of the American people was not measured by interest rates nor determined by fluctuations in the market price of goverment bonds on stock exchanges.
>
> "The Treasury felt, however, that to raise the interest rate to 4-1/2 percent would mean a corresponding increase in the cost of the war and force still higher interest rates on future issues of industrial and other securities, as well as further depress the price of existing long-term bonds. On the other hand, it seemed clear that the time had arrived when every effort should be made to stabilize the interest rate

on government bonds and to reach a point where there would no longer be expectation of further increases in rates."

Thus, the principal reason for establishing a ceiling rate of 4-1/4 percent on long-term Government bonds was the desire to minimize costs associated with U.S. participation in World War I. The ceiling was established at what was, even then, a low level because of the belief that the American public would purchase Liberty Bond issues for reasons other than comparative yield. The Third and Fourth Liberty Bond issues had 18.4 and 21 million subscribers, respectively, representing significant fractions of the total U.S. population, which was only 105 million in 1920. These securities were available in small enough denominations to attract buyers from all sectors of the economy.

Circumstances are different today. The Third and Fourth Liberty Bond issues sold out at prices greater than those prevailing in the market because bonds were available in small denominations, which were attractive to small investors. Thus, convenience compensated for low yield. In addition, patriotic motivations undoubtedly played some part. Today, Treasury bonds (other than savings bonds) are no longer available in denominations sufficiently small to attract many small-scale investors who are relatively insensitive to interest rates. Suppliers of long-term funds to the capital markets are very responsive to such rates. Patriotic motivations will probably not be sufficiently strong to outweigh interest income considerations.

Thus, the 4-1/4-percent interest limitation on long-term Treasury bonds was established to reduce the costs of financing World War I and was set at a level only marginally below the interest rate that would have been charged in its absence. For the next 40 years, interest rates in long-term bond markets never reached levels high enough for the limitation to be relevant. Interest rates in the 1930s were reflective of the great depression and the low demand for money balances; in the 1940s, an easy monetary policy during and after World War II kept yields low. During the 1950s, yields crept upward, and only in late 1959 did they surpass the ceiling. For the first time in 40 years, the ceiling became a relevant constraint on debt management policy.

It appears that the 4-1/4-percent interest limitation was established to minimize the costs of World War I without regard to future borrowing activities. This is consistent with the fact that the limitation was set 0.25 percent below the yields then prevailing in the market. That difference was rationalized on the grounds that a national emergency existed and patriotic motives could be relied upon to insure a sellout of the issues. Were the same sort of legislation enacted in November 1975 under the same philosophy, a ceiling would be set at about 8 percent--about 0.25 percent below the yields then prevailing on the three long-term Treasury issues of 1995 to 2005.

We are not now in a national emergency. Under current circumstances, it is not likely that the Treasury can borrow at interest rates greatly below yields on currently outstanding long-term public debt. Unless one argues that long-term financing should take place only during periods of emergency, when patriotic considerations may override normal investor motivations, to expect that any ceiling should differ from the marginal yield on long-term Treasury debt is unreasonable. Considering the initial intent for imposing the 4-1/4-percent ceiling--to minimize the costs of Treasury borrowing given market conditions in a national emergency--one cannot argue for either the current level or the continued existance of the 4-1/4-percent interest limitation on long-term Treasury debt. It no longer serves to reduce the cost of borrowing; instead, it simply keeps the Treasury from any further borrowing in the long-term securities market.

APPENDIX I

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D C 20220

March 1, 1976

Dear Mr. Havens:

Thank you for your letter of January 27 and the copy of a draft GAO Report to the Congress entitled, "An Analysis of the 4-1/4 Percent Interest Rate Limitation on Long-Term Treasury Debt."

We agree completely with the conclusion in the draft report that "The 4-1/4 percent interest limitation does not reduce the cost of government borrowing and may in fact raise those costs." In fact, the cost of government borrowing would have been significantly lower over the past decade if the Treasury had not been restrained from issuing long-term securities.

In addition, precluding Treasury from borrowing in all sectors of the market imposes unmeasurable, but certainly large, costs on the economy. Those costs are discussed in detail in Secretary Simon's statement before the House Ways and Means Committee on February 17. A copy of that statement is enclosed for your convenience.

We are pleased to note that your report suggests that the Congress may wish to consider:

-- A systematic phasing out of the 4-1/4 percent interest limitation through annual redefinition of the maximum maturity of securities whose flotation is subject to the ceiling; and/or

-- Annual $10 billion increases in the dollar volume of long-term securities which may be floated without regard to the ceiling; or

-- Immediate repeal of the 4-1/4 percent interest limitation.

In this regard, the Treasury proposed to the Congress in 1975 that the amount of long-term debt exempted from the 4-1/4 percent ceiling be increased by $10 billion and that the authorized maturity of Treasury notes be increased from seven years to ten years. Those proposals were renewed this year in the Secretary's statement on February 17, and we welcome your support of them.

Sincerely yours,

Edwin H. Yeo, III

Attachment

Mr. Harry S. Havens, Director
Office of Program Analysis
General Accounting Office
Washington, D. C. 20548

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