TAX RESERVE CERTIFICATES

This article explains what tax reserve certificates are and how they have developed, and discusses their importance in government finance. It goes on to analyse the holdings of the certificates, and why they fluctuate. Some new statistical tables are given at the end of the article.

Tax reserve certificates are issued[a] in multiples of £5 by the Bank of England on behalf of H.M. Treasury. They must be paid for in full on application, which can be made direct to the Bank or through most commercial banks. Holders normally surrender the certificates within two years to the Inland Revenue in settlement of certain taxes, particularly income tax (unless deducted at source or collected under Pay As You Earn arrangements), profits tax and surtax. Certificates surrendered in this way earn interest, which runs to the date when the tax is deemed to be due. But this interest is not paid in cash; it is added to the value of the certificate, thus enabling more tax to be paid by this means. Certificates can be surrendered to the Inland Revenue at any time after they have been held for two months, but no more than twenty-four months' interest can be earned on a certificate. Once they have been held for two months, certificates can always be surrendered to the Bank for repayment in cash, but will then earn no interest at all. The Treasury announce from time to time the rate of interest at which certificates will be issued, but variations in the rates do not affect certificates which have already been issued. The interest, which is exempt from income tax, surtax and profits tax, is at present[b] at the rate of $2\frac{1}{2}\%$ per annum.

The start of tax reserve certificates Tax reserve certificates were first issued towards the end of 1941. Lord Keynes, visiting the United States for H.M. Treasury in the summer of that year, was impressed by the advantages of a new scheme whereby the U.S. Treasury were offering tax payers an inducement to discharge their obligations early. This took the form of a special type of interest-bearing security, then commonly known as a " tax prepayment certificate ".

In the United Kingdom a system of deducting tax at source from wages and salaries had recently been introduced (the forerunner of the Pay As You Earn arrangements). Interest and dividends were already normally taxed at source; and under other long-standing arrangements a discount of $2\frac{1}{2}\%$ per annum was allowed for advance payment of Schedule D income tax (on the profits of trades, businesses and professions). But nothing had been done to hasten the flow of other taxes, such as excess profits tax and surtax, to the Exchequer, and, because government expenditure was rising fast, bank deposits were mounting and arousing fears of inflation. The then Chancellor of the Exchequer (Sir Kingsley Wood) was anxious to allay these anxieties, and to encourage a more rapid and even flow of revenue to the Exchequer, so that the war could be financed as smoothly and cheaply as possible. He also wished to help tax payers to set aside tax monies as their profits or incomes accrued.

On the 16th December 1941 the Chancellor announced the issue of tax reserve certificates. In many respects they resembled the American instrument. The interest offered was 1% per annum free of tax, and lists opened on the 23rd December. The new arrangements superseded the discount for prepayment of Schedule D income tax.

The certificates quickly became popular and applications soon reached an annual rate of about 40,000. The value of certificates held rose steadily; by the end of September 1942 it was £376 million, and three years later £752 million (see Table I on page 183).

(a) This article does not seek to give a full description of the present or past conditions of issue; this will be found in the prospectuses themselves.

(b) 25th August 1962.

Developments since 1945 The rate of interest was reduced to $\frac{3}{4}$% free of tax in April 1946. It has subsequently been changed on twenty-one occasions. The highest rate reached was $3\frac{1}{2}$%, in the later months of 1957 and the early part of 1958, and again during part of the second half of 1961. Full details are given in Table II on page 184.

Apart from changes in the interest rate, the arrangements introduced in 1941 remain broadly unaltered and there have been only two significant modifications. The first was made in 1955. Until then it had been necessary to issue a new prospectus and a new series of certificates whenever the rate was changed. But the prospectus for the seventh series of certificates issued in July of that year enabled H.M. Treasury to alter the rate of interest for further issues of certificates in the current series and to notify the new rate in the *London Gazette*. The second main modification was made in 1961, when the minimum denomination of a certificate was reduced from £25 to £5; and holders who tender, in payment of their taxes, a certificate which is worth more than the tax due can now obtain a fresh (or "balance") certificate, bearing the same date and terms as the original, for the exact amount of the excess, so long as it amounts to at least £5. Previously such holders could obtain balance certificates in multiples of £25 only, any smaller amounts being repaid in cash and not earning interest.

The place of tax reserve certificates in government finance Tax reserve certificates were introduced in the first place as a wartime expedient, in circumstances in which it was important to minimise the effect of government expenditure on the money supply and to divert back to the Government at the earliest possible moment funds accruing in the hands of citizens. The end of hostilities did not immediately alter the circumstances, and it was natural that this now familiar addition to the scope of government borrowing should be continued without a break. In peacetime their main advantage lies in helping to reduce seasonal fluctuations in the movement of revenue. The advantages of the present methods of assessing and collecting direct taxation, other than that deducted at source, are purchased at the expense of a marked seasonal pattern in the Budget over the four quarters of the financial year. During 1961/62, for example, the Budget moved through deficit to surplus as follows:

£ millions

Calendar Quarters	Ordinary Revenue	Total Expenditure[a]	Deficit/ Surplus
April—June	1,317	1,585	−268
July—September ...	1,317	1,740	−423
October—December ...	1,313	1,668	−355
January—March ...	2,698	1,863	+835

[a] Ordinary expenditure plus net expenditure below the line.

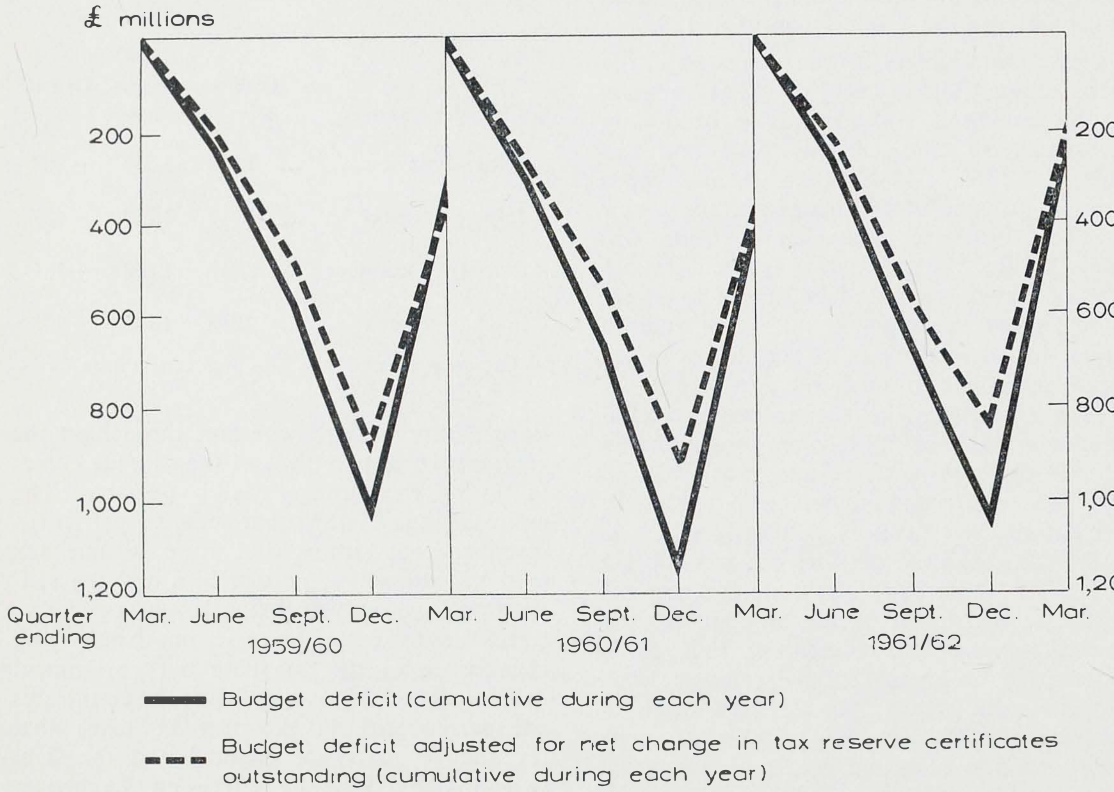
Expenditure is fairly constant throughout the year, but some two-fifths of the revenue comes in during the January-March quarter. The extra revenue in this quarter is, in particular, revenue from surtax, and from income tax paid by companies, partnerships and the self-employed. Strictly speaking, when tax reserve certificates are issued taxes are not thereby paid in advance of the due date but government debt is created. It is only when the certificates are surrendered in payment of taxes that revenue accounts are credited and the debt is cancelled: but the effect on Exchequer financing is the same as if the revenue came in early. The effect can be seen in Graph 1. During 1961/62, for example, the net issue of certificates served to reduce the crude budget deficit by some £200 million in aggregate during the first three quarters, and the budget surplus by some £185 million in the fourth quarter.

It is true that seasonal variations in the position of the Exchequer can be and are dealt with by variations in other types of government borrowing, notably of course on Treasury Bills. Such variations are reflected in the liquid assets of the banking system: during the past ten years the liquidity ratio of the clearing banks has risen on average by some four points between March and December, and fallen similarly between December and March. If tax reserve certificates did not

GRAPH 1

EFFECT OF TAX RESERVE CERTIFICATES

ON THE BUDGET OUTTURN



exist, and all the money at present invested in them were held in bank deposits instead of government debt, the fluctuation in the liquidity ratio might be five points instead of four. The effect of the certificates in moderating seasonal fluctuations in the banking figures must therefore be regarded as modest.

Nevertheless, tax reserve certificates have their advantages as a form of borrowing. They do smooth the path of tax collection by provision in advance. They are a type of debt which once taken up is likely to be held: they are not transferable, and carry a deterrent against encashment because interest is earned only if the certificates are used to pay tax. Their probable effect is to increase the total of direct holdings of government debt.

The use made of tax reserve certificates

The total value of certificates outstanding has changed little, other than seasonally, ever since 1947 (see Table I), even though the tax which could be paid by tax reserve certificates has increased considerably. The stability in the total seems to be due to some falling off in purchases by companies; the figures of applications in Table III on page 185 suggest that—at least up till March 1962—" persons " have been buying more certificates than formerly. These changes are dealt with more fully below.

The latest figures showing the tax which could be paid with tax reserve certificates and the tax in fact paid in this way are for 1960/61 :

£ millions

	Total tax paid	Paid with t.r.c.'s.
Income tax (other than tax paid under P.A.Y.E., deducted at source, etc.) ...	1,438	264 (18%)
Profits tax and excess profits levy	268	49 (18%)
Surtax	192	36 (19%)

The proportion of surtax paid with tax reserve certificates has tended to rise in recent years; the proportion of other tax paid with the certificates has moved erratically, but within fairly narrow limits.

All the surtax is due on the 1st January, each year, and nearly all the income tax; profits tax is due at various dates during the year.

Before considering whether it would be reasonable to expect a greater use of tax reserve certificates, it is necessary to examine the various types of holder, and the rates of interest paid on the certificates.

The holders of tax reserve certificates Holders of tax reserve certificates fall into two groups. First, private individuals and partners in unincorporated businesses who buy certificates mainly to pay surtax—though some professional and self-employed people provide by this means for income tax; and secondly, companies, together with a few public corporations, which buy certificates to pay income tax and profits tax. The Bank keep no register which would show the total number of *holders* in either or both groups. But because the number of *subscriptions* are known, and because it is also known that each holder who pays tax with tax reserve certificates surrenders on average about three certificates with each tax payment, and holds his certificates for about a year on average, it is possible to estimate the total number of holders within broad limits. This total may have been some 30,000–40,000 in 1961.

The Bank have kept special records of both issues and surrenders of certificates since 1957 to show in which of the two groups the holders fall (" Persons " or " Other "). These records (summarised in Table III) show that personal holdings represent a small proportion of the total value (about 15% in all) but have risen steadily year by year both in number and value. This increase continued during 1961. The Budget in April of that year had made reductions in surtax so that less money needed to be set aside for payment in January 1963; but an increasing number of surtax payers were perhaps still making provision for tax due in January 1962 (on income received before April 1961). Higher sales of certificates during 1961 can in part be attributed to a publicity campaign which, by press advertising and leaflet, drew the attention of surtax payers to the attractions of the certificates. In spite of the favourable return to surtax payers, however, it still seems that no more than perhaps one surtax payer in twenty has been buying tax reserve certificates.

While holdings of private individuals have risen steadily in recent years, other holdings (mainly of companies) have not (see Table III). One reason for this is that there has been little secular growth in the total of tax paid by companies. From year to year, however, these " other " holdings fluctuate considerably, partly no doubt as company profits fluctuate and partly as the interest rate on the certificates becomes more or less attractive than that on other investments. Companies' views about the desirability of keeping funds readily available for use in the business, rather than in tax reserve certificates, may also vary from time to time, depending, for example, on whether credit is easy or difficult to obtain.

The different ways in which the two groups react to changes in the interest rate can best be seen by comparing them on occasions when a change has been expected. It will be seen that " personal " holders, many of whom buy regularly (often by standing order to their bankers), are not greatly influenced by a prospective change, while other holders are.

A good example of delay in purchasing certificates occurred just after Bank Rate had been raised on the 25th July 1961. The turn of a month is normally the time when most applications for certificates reach the Bank.[a]

[a] This is because a large proportion of tax is payable on the 1st January and the 1st July. If applications for certificates reach a commercial bank on or before the first day in a month the Bank will in due course issue a certificate which will earn interest for that month. Interest is not earned for part of a month.

But " other " purchases during the six working days to the 3rd August were very much lower than during the comparable period a year earlier, when no change in the rate was expected:

	Persons		Other	
	Number	Value	Number	Value
		£ thousands		£ thousands
6 days to the 3rd August 1961...	3,624	1,386	718	2,738
6 days to the 3rd August 1960...	3,336	649	963	27,734

Early in August 1961 the rate was raised, and purchases by companies at the end of that month were heavy. Many of them had clearly preferred to forgo a month's interest or earn it elsewhere, so that they might obtain a higher return on the rest of the life of the certificate.

A good example of a speeding up of purchases, rather than a slowing down, occurred in the nine working days to the 29th March 1958. Bank Rate had just been reduced, and a fall in the tax reserve certificate rate was expected. Thus there were much heavier purchases of certificates by both persons and other holders in advance of the end of the month than a year earlier (when no change in the rate was expected):

	Persons		Other	
	Number	Value	Number	Value
		£ thousands		£ thousands
9 days to the 29th March 1958 ...	1,893	2,453	1,227	32,143
9 days to the 29th March 1957 ...	1,155	1,068	713	9,826

The rate of interest on tax reserve certificates

In fixing the rate of interest, H.M. Treasury have to reconcile the opposing aims of minimising the cost of borrowing and encouraging subscriptions to the certificates. So far as possible the rate of interest is kept in line with other short-term rates. There is, however, no strictly comparable security to act as a guide. In the first place, the interest on the certificates is free of tax; and, secondly, it is fixed for up to two years, whereas the yield on Treasury Bills, a natural competitor for the funds of companies and other very large tax payers, is fixed for no more than 91 days. Generally there is a very short-dated government stock with which to compare the yield on tax reserve certificates; but the attraction of such a bond to a large surtax payer (or a company) depends to a substantial extent on the coupon; he might also want a stock with a redemption date near the date when the tax was due. Other comparisons are with deposits with banks, building societies, local authorities, or hire purchase finance companies, or with local authority mortgages. All these will often give a higher nominal return than the certificates but the interest will be liable to income tax (except deposits with building societies) and to surtax, and some may change at short notice. The best guide to the right rate for the certificates is the inflow of subscriptions.

Prospective purchasers may be influenced not only by a comparison of rates at the time, but also by their estimate of likely changes in short-term rates generally. If rates are expected to rise, many will hesitate to choose an investment which cannot be encashed and replaced by a higher yielding investment without sacrificing the interest which has been earned. Subscribers who are neither concerned about their liquidity nor anxious to take a view about the likely course of short-term rates are interested mainly in the return currently offered. For a tax payer with only a small surtax liability the gross effective rate of return is roughly twice the nominal rate on the certificate; for those with higher incomes the effective return can be very much greater. For companies with income tax and profits tax liabilities the effective rate of return is approximately twice the nominal rate on the certificate.

Methods of encouraging purchases of tax reserve certificates

Three ways of encouraging purchases of tax reserve certificates have been considered by the Government. First, publicity: because most companies have financial advisers who can be expected to be aware already of the advantages of the certificates, this has been directed towards surtax payers, and appears to have achieved results. It will no doubt be continued in a modest way, even though the 1961 Budget has reduced the numbers of those who would otherwise have been due to pay surtax on the 1st January 1963 from some 500,000 to under 350,000.

Secondly, making the interest rate more attractive : this would be costly to the Exchequer, because the higher rate would have to be paid not only on the additional new certificates sold but also on the new certificates which would have been sold anyway. An unduly high rate might also throw doubt on the existing level of gilt-edged prices. Moreover, the rate is already generous to large surtax payers. The rate is reasonably attractive to companies also. But even if it were higher many companies would still decline to buy certificates, either on liquidity grounds or because they considered they could obtain a greater return on their money by employing it in their businesses.

A third possibility which has been considered is an extension of the two year life of the certificate. This would mean a change in the character of the instrument which is a method of setting aside tax monies as income or profits accrue. The two year period is generally long enough for this purpose. For example, most of the surtax due on the 1st January 1962 related to income received over the period April 1960—March 1961, that is not more than twenty-one months earlier. The income tax due by companies on the 1st January 1962 related to the earnings of companies whose financial years ended between the 1st April 1960 and the 31st March 1961. That is to say, the companies paying tax on the 1st January 1962 started to earn the related income between thirty-three and twenty-one months earlier; and much the greater part of it must have been earned within the two year period.

In any case, it is doubtful whether an extension of the period would in fact bring in many more subscriptions. Certain samples of the length of a certificate's life have been taken at different times during recent years when certificates have been surrendered. The life has varied widely because holders tend, if they can, to surrender certificates bearing lower rates of interest and to keep those bearing higher rates; and sometimes the newer certificates carry the higher rates and sometimes the older certificates. But no sample showed a high proportion of certificates with a full two years' life. The most recent sample was taken by the Bank of England for certificates surrendered in January 1961. It suggested that the most common life of a certificate was twelve months, and the average life fourteen months. The distribution by months is illustrated in Graph 2.

The administration of the tax reserve certificate system

The administrative costs of the tax reserve certificate system are not particularly heavy, and taking into account the amount of money raised it is probably in that respect a fairly cheap form of government borrowing. It is, however, difficult to find a fair standard of comparison. Although some forms of National Savings, for example, are costly to administer because the turnover is high, social considerations apply more strongly in their case. The administration of tax reserve certificates falls partly on the Inland Revenue, which receive the certificates when they are used to pay tax, and partly on the Bank of England, which issue the certificates, and, when in due course the surrendered certificates are forwarded by the Revenue, deal with the interest and repay any balance of principal due to the holder. The Bank also repay any certificates surrendered for cash, and print and distribute prospectuses and subscription forms. The number of staff engaged on the work in the Bank fluctuates considerably. There may be as many as sixty people dealing with issues and surrenders in the January—March quarter, and as few as fifteen at other times in the year.

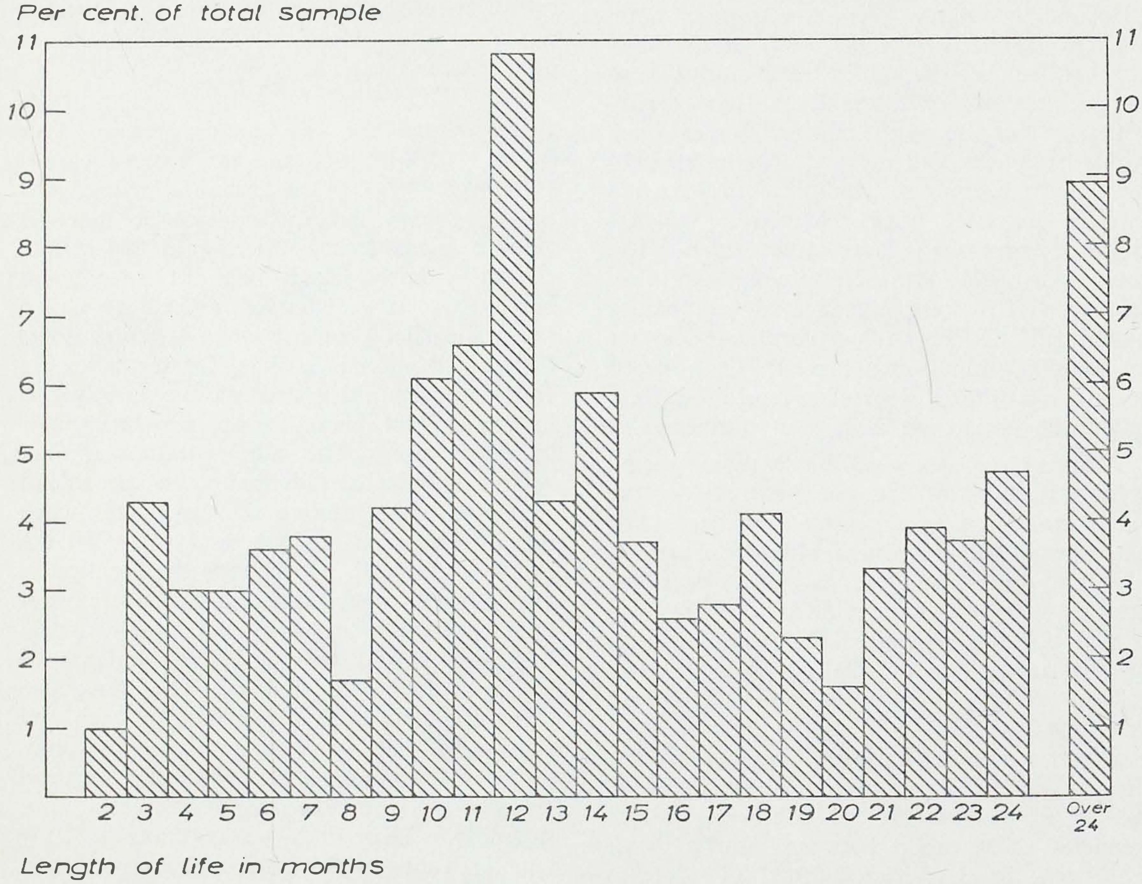
Comparable instruments abroad

Most other West European countries seem to have less need for such a system of tax reserve certificates, because their revenue peaks are smaller. In some of them a much smaller proportion of all taxes is collected by the Central Government than in the United Kingdom and, because the local authorities frequently have different dates on which tax is due, taxes tend to come in more regularly during the year. In most of them also a higher proportion is collected in the form of indirect taxation.

The only close parallel with the United Kingdom's system of tax reserve certificates is in Ceylon. There are arrangements with some

GRAPH 2

LENGTH OF LIFE OF A SAMPLE OF TAX RESERVE CERTIFICATES SURRENDERED IN JANUARY 1961



common features in South Africa, Western Germany (Bavaria) and in some South American countries.

The U.S. Treasury still issue Tax Anticipation Bills but they are now quite different in character from the tax reserve certificates in this country. Interest on the U.S. certificate is subject to tax, and is paid whether or not the certificate is used to pay tax. Moreover, the certificates are not 'on tap', but are offered for subscription up to a specific amount on a single day. They are also transferable, and can be purchased in the market, for example, from a government security dealer.

Table I[a]

£ millions (except where stated)

Year ended 30th Sept.	Applications			Surrenders			Change during year	Outstanding at end of period
	Number (*thousands*)	Value	Average value per application (*£ thousands*)	Cancelled in payment of taxes	Repaid without interest	Total		
1942	33	406	12·3	28	2	30	+376	376
1943	42	500	11·9	301	4	305	+195	571
1944	46	521	11·3	401	7	408	+113	684
1945	45	516	11·5	442	6	448	+ 68	752
1946	33	365	11·1	452	11	463	− 98	654
1947	23	248	10·8	374	13	387	−139	515
1948	24	277	11·5	306	11	317	− 40	475
1949	24	275	11·5	335	10	345	− 70	405
1950	24	308	12·8	274	7	281	+ 27	432
1951	24	386	16·1	301	12	313	+ 73	505
1952	25	335	13·4	362	42[b]	404	− 69	436
1953	27	357	13·2	341	7	348	+ 9	445
1954	29	438	15·1	316	5	321	+117	562
1955	32	387	12·1	373	117[b]	490	−103	459
1956	49	424	8·7	364	40[b]	404	+ 20	479
1957	59	381	6·5	356	10	366	+ 15	494
1958	71	387	5·5	374	17[b]	391	− 4	490
1959	72	288	4·0	290	5	295	− 7	483
1960	84	375	4·5	352	24[b]	376	− 1	482
1961	101	347	3·4	340	5	345	+ 2	484

(a) The figures in this table come from the Bank's records. They show the number and value of applications received in the Bank, and the value of certificates surrendered to the Bank, during each year. There is a timing difference between these figures and those for the latest years ended the 30th September which can be extracted from Table III.

(b) These surrenders were largely offset by purchases of new certificates bearing a higher rate of interest.

Table II

Rate of interest *per cent. per annum*	From	Series
1	23rd December 1941	First
¾	15th April 1946	Second
1¼	16th July 1952	Third
1	14th July 1954	Fourth
1¼	21st February 1955	Fifth
1½	21st March 1955	Sixth
1¾	11th July 1955	Seventh
2½	10th September 1955	
3	29th February 1956	
3½	25th September 1957	
3¼	29th March 1958	
3	7th June 1958	
2½	20th August 1958	
2¼	29th November 1958	(a) Eighth (from the 7th January 1959)
2½	27th January 1960	
2¾	28th May 1960	
3¼	29th June 1960	
3	26th November 1960	(b) Ninth (from the 21st March 1961)
3½	12th August 1961	
3¼	25th November 1961	
3	24th March 1962	
2¾	28th April 1962	
2½	25th August 1962	

(a) This series was introduced to take account of the special tax position of Overseas Trade Corporations following the Finance Act, 1957.

(b) This series provided for the issue of certificates of £5 denomination, instead of £25, and made certain other changes to the conditions of issue.

Table III

Calendar quarters and financial years		Issues Persons(a) Number of applications (thousands)	Issues Persons(a) Value (£ millions)	Issues Other(b) Value (£ millions)	Surrenders Persons(a) Value (£ millions)	Surrenders Other(b) Value (£ millions)	Net change in certificates outstanding Persons(a) Value (£ millions)	Net change in certificates outstanding Other(b) Value (£ millions)
1957	1st quarter	9·9	9·2	136·4	21·4	297·7	−12·2	−161·3
	2nd „	9·1	7·2	70·9	1·9	10·4	+ 5·3	+ 60·5
	3rd „	8·9	6·9	78·5	1·4	20·5	+ 5·5	+ 58·0
	4th „	11·2	9·6	60·8	1·9	19·1	+ 7·7	+ 41·7
1958	1st „	10·9	10·2	123·1	24·9	303·9	−14·7	−180·8
	Total	40·1	33·9	333·3	30·1	353·9	+ 3·8	− 20·6
	2nd quarter	12·9	12·7	73·7	2·2	12·0	+10·5	+ 61·7
	3rd „	11·4	10·7	80·2	3·5	16·8	+ 7·2	+ 63·4
	4th „	11·8	16·0	68·3	1·9	6·4	+14·1	+ 61·9
1959	1st „	13·4	11·6	65·7	25·8	226·7	−14·2	−161·0
	Total	49·5	51·0	287·9	33·4	261·9	+17·6	+ 26·0
	2nd quarter	14·3	12·3	43·8	2·7	9·1	+ 9·6	+ 34·7
	3rd „	13·3	9·7	60·2	4·5	16·8	+ 5·2	+ 43·4
	4th „	14·2	11·7	57·9	3·0	9·1	+ 8·7	+ 48·8
1960	1st „	16·1	13·6	106·7	32·1	272·9	−18·5	−166·2
	Total	57·9	47·3	268·6	42·3	307·9	+ 5·0	− 39·3
	2nd quarter	16·6	14·1	45·4	2·4	11·9	+11·7	+ 33·5
	3rd „	17·1	12·1	102·2	4·8	28·7	+ 7·3	+ 73·5
	4th „	17·4	14·4	92·0	3·4	9·0	+11·0	+ 83·0
1961	1st „	19·0	14·4	76·4	36·8	251·8	−22·4	−175·4
	Total	70·1	55·0	316·0	47·4	301·4	+ 7·6	+ 14·6
	2nd quarter	22·9	15·1	46·7	3·2	13·7	+11·9	+ 33·0
	3rd „	20·6	13·2	75·3	4·4	22·3	+ 8·8	+ 53·0
	4th „	19·4	16·0	97·5	3·7	11·6	+12·3	+ 85·9
1962	1st „	19·5	14·9	106·1	42·9	263·5	−28·0	−157·4
	Total	82·4	59·2	325·6	54·2	311·1	+ 5·0	+ 14·5
	2nd quarter	18·1	10·5	51·2	3·2	9·8	+ 7·3	+ 41·4

(a) Figures for " persons " are from the Bank's records. They include partnerships and private firms as well as individuals. The figures are designed to be used with other statistics of personal savings in the national income accounts. The figures of issues therefore relate so far as possible to the dates on which the applicant's bank account was debited. Since most applications reach the Bank of England through a commercial bank, the date of debiting is normally some time before the date when the application reaches the Bank. To allow roughly for this delay, all applications received at the Bank during the first three working days of a quarter are included in the figures for the previous quarter.

(b) " Other " holders cover any holdings by limited (or chartered) companies, building societies, co-operatives, the nationalised industries and local authorities. The figures are calculated by subtracting the figures for " persons " from the total amounts received into and paid out of the Exchequer in each calendar quarter on account of t.r.c.'s. These residual figures therefore reflect the three day difference of timing between the Exchequer returns and the figures for " persons ". It is possible to calculate the number of applications by " other " holders very approximately by subtracting the number of issues to persons from the total number of applications (Table I). During the year to September 1961, for example, " other " applications probably totalled about 20,000. A special enquiry has shown that these applications were probably spread fairly evenly over the four quarters.