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Business Conditions

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through DISCs**

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Promoting U.S. exports through DISCs

Over the past 10 years the volume of world trade (as measured by exports of 124 free-world countries) rose almost fivefold and amounted to \$790 billion in 1975. This rapid increase in world trade reflects the tremendous growth of economic interdependence between nations. The economic activities of each nation have become increasingly tied to its exports and imports. International trade has not only represented the means of obtaining essential raw materials and other goods from abroad, but also a channel to new markets for the output of the nation's factories and for its natural resources. The growth in the countries' exports provided at least in part the means to their economic growth. It is therefore not surprising that in the post-World War II sociopolitical environment, in which the governments of virtually all nations became increasingly committed to the promotion of economic growth as a means toward domestic full employment, the governments became increasingly involved in the promotion of their countries' exports. The U.S. Government has been no exception to this trend. Its export promotion programs expanded particularly during the late sixties as the traditional U.S. trade surplus began to be eroded under ever larger inflows of imports.

The government's involvement in export promotion programs within the framework of market-oriented economies, where international transactions typically take place at the initiative of private individuals and corporations in pursuit of

profit objectives, raises some important issues relating to social costs and benefits. An article in the December 1975 issue of *Business Conditions*—"How Useful are Export Promotion Programs?"—focused on the U.S. Government promotion of exports through the provision of special export credit facilities; this article explores the implications of another major means of government export promotion—preferential tax treatment of exporters.

Historical background

Government efforts to promote their countries' exports have a long history. In the 17th and 18th century, under the doctrine of "mercantilism," governments promoted exports as a means of securing inflows of gold and silver, the store of which—according to the thinking of the time—was viewed as the source of national wealth and power.

While the basic premises of mercantilism have long since been discredited, official governmental policies to promote exports have continued to be used in the modern world. Their objective became increasing domestic economic growth and employment. The policies proliferated during periods when individual nations experienced unemployment, as for example, during the Great Depression in the thirties. In a static world, however, one nation's gain was another nation's loss. Higher exports of one nation invariably displaced exports and/or domestic production of

other nations; improvements in employment in the export-expanding country were matched by reductions in employment in other countries. Governments of the affected countries responded by imposing restrictions on imports or by adopting export promotions and subsidies of their own. The result was a contraction of world trade that contributed to the spread of world economic depression.

Following World War II, a great majority of trading nations participated in establishing various international treaties and agreements designed to prevent such disruptions and self-defeating trade policies. For example, the General Agreement on Tariffs and Trade (GATT) was established in 1948. It developed a comprehensive set of rules which participating nations were expected to follow in national trade policies. The International Monetary Fund (IMF), established in 1945, developed a comprehensive set of rules embodied in the Articles of Agreement, to which virtually all free-world nations subscribed, establishing the international monetary system and defining the exchange rate policies member countries must follow. Competitive devaluation of one's currency for purposes of gaining an unfair advantage in the world's export markets was "outlawed," and a system of relatively "fixed" exchange rates was established as the centerpiece of international monetary arrangements.

These, as well as other international arrangements designed to foster the growth of international trade, largely achieved their purpose. The world's trading nations have since enjoyed an environment increasingly free from barriers or artificial stimulants of international trade. However, certain features of the system proved too rigid. In trying to develop a system that would avoid the self-destructive mistakes of the past, the architects of the postwar system did not provide enough flexibility to permit

smooth adjustments to long-term secular changes. The regime of fixed exchange rates, while in theory guarding against competitive exchange rate policies, proved in practice too rigid to accommodate the varied rates of growth and economic developments that materialized following the reconstruction of the world economy from the ravages of the war. The exchange rate structure established shortly after the war stayed largely unchanged for many years despite the tremendous disparity in economic growth among world countries that developed over that period. Inevitably, relative exchange rates that fail to properly reflect the relative economic standing of individual nations will lead to disequilibria in the balance of payments of individual countries: countries whose currencies are undervalued relative to their economic "strength" will experience chronic surpluses and countries whose currencies are overvalued will experience prolonged deficits in their balance of payments.

By the mid-1960s the United States found itself in a position whose currency became increasingly overvalued in terms of currencies of countries registering rates of economic growth far exceeding that of the United States—particularly European and Asian countries. Yet, given the key position of the U.S. dollar as the reserve currency, it was felt that a unilateral devaluation of the dollar that would bring the exchange rate into a more realistic alignment with the rest of the world would be too disruptive and, as such, unacceptable to U.S. trading partners and the rest of the world. Thus the U.S. Government tried to correct the disequilibrium in the country's balance of payments by special measures. In 1964, when the misalignment of the exchange rates manifested itself largely by excessive outflow of capital, the government adopted restrictions on capital outflows. But as the sixties progressed, the misalignment took its toll

on the U.S. trade account. The traditional surplus in U.S. international trade was gradually disappearing until, in the early 1970 s, the United States was faced with its first trade deficit in more than a century. The government responded with efforts to stimulate U.S. exports. Among other things it authorized the establishment of special tax shelters that would give tax advantages to U.S. exporters. These entities were to be called Domestic International Sales Corporations—DISCs.

What is the DISC?

The Revenue Act of 1971 permitted U.S. firms to establish special subsidiaries—the DISCs—and authorized the firms to allocate to these up to 50 percent of their net income derived from export sales. The DISCs were then authorized to defer indefinitely 50 percent of taxes due on this income, provided the following conditions are met:

1. A DISC must have equity capital of at least \$2,500 in the form of one stock class. Stockholders may be individuals, corporations, partnerships, or trusts and estates, including nonresident foreigners.
2. A DISC must derive at least 95 percent of its receipts from “qualified export receipts” and have at least 95 percent of its assets in “qualified export assets.”
3. A DISC’s earnings must be used in its export business, invested in certain types of Export-Import Bank obligations, or used to finance export-related assets.

The objective of the DISCs has been to provide U.S. exporters with tax incentive to increase exports. This, in turn, it was reasoned, would help improve the U.S. balance-of-payments position and provide incentives for U.S. firms to expand their U.S.-based export production as a more profitable alternative to investing overseas and thus reduce outflows of capital

and contribute to increased U.S. employment and income.

The number of DISCs in operation grew rapidly, reaching 8,382 by the end of February 1976. On June 30, 1974 (the end of the fiscal year 1974 and the latest period for which detailed data on DISC operations are available) there were 4,162 DISCs in existence. Their gross receipts, derived from sales of goods and services qualified under DISC legislation, amounted to \$44.4 billion during that fiscal year. Manufactured products represented roughly two-thirds, and nonmanufactured products and services about one-third of this total. In the latter category the export sales of agricultural products represented almost the entire amount, while in the manufactured products category the sale of transportation equipment represented the largest group.

A great majority (3,384) of DISCs in existence at the end of fiscal year 1974 were majority-owned by a single corporation, usually as an extension of that corporation’s export sale activities. The gross receipts of these corporate-owned DISCs amounted to \$43.3 billion during fiscal year 1974. The DISCs established by the largest U.S. corporations accounted for most of the sales. For example, of the 2,333 DISCs for which the size of the parent institution is known, 483 (or some 21 percent) were set up by U.S. corporations whose total assets exceeded \$100 million; these DISCs accounted for about 73 percent of the \$41.5 billion in export sales within the group. On the other end of the spectrum, firms with assets of less than \$5 million were majority owners of 836 DISCs—while 36 percent of the total number, they accounted for only 4 percent of receipts.

The net income of all DISCs in existence at the end of fiscal 1974 amounted to \$3.1 billion, with \$2.9 billion accruing to corporate-owned DISCs for which a breakdown of corporate size is available. About 77 percent of this total accrued to

DISCs owned by corporations with assets over \$100 million, while about 5 percent accrued to those owned by corporations with assets less than \$5 million.

Costs and benefits of DISCs

The indefinite corporate tax deferral granted to DISCs may be viewed as a tax subsidy extended to exporters by the U.S. Treasury. Obviously, there is a cost attached to this type of tax subsidy. This cost has to be borne by society—just as the cost of military equipment or social provisions supplied by the national government must be borne by ordinary taxpayers. What has been the cost of DISCs? The U.S. Treasury has estimated that the cost of DISCs, as measured in terms of revenues lost to the U.S. Treasury, has been \$3.4 billion for the years 1972-75 and is expected to run about \$1.5 billion annually in the foreseeable future.

On the other hand, certain benefits have been expected to accrue to the American public from the DISCs. The direct benefit sought by the government in establishing DISCs was to improve the country's balance-of-payments position. A by-product of any improvements achieved by DISCs in this area would be benefits relating to the country's economic growth and employment. The crucial questions in evaluating the merits of the DISC arrangement are, then, to what extent have these benefits materialized, and what have been the costs that the society as a whole had to pay to achieve them?

Two major studies of DISC impacts were carried out recently, one by the Department of the Treasury¹ and the other by the Library of Congress.² The main argument in the study undertaken by the

Treasury is that the DISC has substantially increased U.S. exports by focusing the attention of U.S. firms on new export opportunities. According to the Treasury, firms faced with the prospect of higher export profits due to preferential taxes on exports might: (1) seek new foreign markets, (2) export products previously only profitable to sell in the United States, (3) give priority to export sales, (4) expand export production capacity using DISC income, (5) provide increased credit to foreign buyers through increased DISC income. The Treasury concludes that exports attributable directly to the existence of DISCs totaled \$1.9 billion in 1973 and \$4.6 billion in 1974, and created 230,000 new jobs.

The Library of Congress Congressional Research Service (CRS) study takes a different approach in examining the impact of DISCs. The study's basic premise derives from the proposition that an increase in exports can be achieved only through a reduction in the prices of exported goods on world markets. For a reduction in profits taxes to be an effective stimulant to exports it must lead to reduced prices of goods. That is, for DISCs to be an effective stimulant to exports, the savings realized by the corporation through the reduction in corporate profits tax must be "passed-through" to ultimate consumers abroad in the form of lower prices of exports, and the consumers must respond by increasing their demand. Thus, the impact of the DISCs, according to the CRS, depends on the extent of the pass-through, and on the extent to which the volume of exports actually increase in response to the lower prices. The sensitivity of foreign demand to price changes is statistically measured by the "price elasticity of de-

¹Department of the Treasury, "The Operation and Effect of the Domestic International Sales Corporation Legislation," 1974 *Annual Report*, Washington, April 1976.

²Gravelle, Jane; Hughes, Kent; and Farb, Warren E., "The Domestic International Sales Corporation (DISC) and its Effect on U.S. Foreign Trade and Unemployment," Congressional Research Service, Library of Congress, Washington, D.C., May 4, 1976.

mand." Using statistically estimated price elasticities of 1.5 to 2.85 (suggesting that for each 1 percentage point reduction in prices, the demand for U.S. exports increases between 1.5 and 2.85 percent), and assuming a tax pass-through ranging from zero to "full pass-through," the CRS estimated that in 1974 U.S. exports were increased by up to \$1.35 billion as a result of the stimulative impact of DISCs if the tax savings were fully passed on to the foreign consumers. If no pass-through occurred, then the volume of exports remained the same as they would have without the DISC subsidy, the CRS concluded. The CRS also estimated that the DISC possibly resulted in up to 104,000 new jobs if full pass-through occurred, and in no changes in employment under a zero pass-through assumption.

The estimates of the benefits resulting from the DISCs thus range over a wide spectrum and leave some doubts about the merits of DISCs. These doubts are further reinforced where the contemplated impact of DISCs is considered within the context of changes that have taken place in the international monetary arrangements since their introduction in early 1971.

As indicated above, the primary rationale for the DISC proposal was the improvement in the U.S. balance of payments in an environment where an improvement through more conventional means (such as devaluation) was deemed impractical. However, shortly after the introduction of DISCs, the pressures on the entire international monetary system generated by the misalignment of exchange rates proved too strong to resist. The existing exchange rate structure was abandoned and the U.S. dollar was devalued, first in December 1971, and again in February 1973. Moreover, in early 1973 major trading countries adopted a system of floating exchange rates—a system where the exchange value of a country's currency is generally permitted

to move up or down in response to the supply and demand conditions in the foreign exchange markets. The dollar devaluation removed the rationale for the DISC; the floating exchange rate system made it difficult, if not impossible, to achieve the sought-after benefits.

Under the floating exchange system any increase in U.S. exports achieved through the export subsidy is accompanied by an increase in demand for U.S. dollars as foreign importers attempt to obtain U.S. funds to pay U.S. exporters. This increase in demand, other things equal, tends to drive up the "price" of the U.S. dollar on the foreign exchange markets, i.e., the exchange rate of the dollar relative to other currencies rises. An increase in the price of the dollar in terms of foreign currencies, of course, directly translates into higher prices for U.S. goods on world markets. Higher prices typically mean a lower demand; all U.S. exports tend to decline. The exchange rate movements also impact on the country's imports. A rise in the exchange value of the dollar makes foreign goods cheaper for U.S. residents. Lower prices tend to increase the demand for foreign goods in the United States, leading to more imports.

Accepting the conclusions of either study suggesting that certain U.S. exports were initially increased by the DISC subsidy, one must also accept the consequences of that increase operating within the regime of relatively freely floating exchange rates: reduced exports, particularly of nonsubsidized goods, and increased imports. A reduction in exports and an increase in imports will tend to reduce the country's economic growth as measured by the GNP, will tend to displace some U.S. workers previously employed in domestic production, and will tend to erode the country's balance-of-payments position. In sum, the market forces unleashed by the DISC subsidy tend to negate the benefits possibly initially achieved by the subsidy.

The society, under these circumstances, is left with “footing the bill” for the subsidy while deriving few, if any, benefits from it.

The DISCs and the GATT

The General Agreement on Tariffs and Trade established rules designed to prevent unfair trade practices by member nations. Among these are rules concerning domestic tax rebates and concessions that benefit exports. On the assumption that *indirect taxes* (such as sales taxes) are passed directly on to the consumer, while *direct taxes* (such as corporate profit tax) are absorbed by the producers, the GATT rules permit rebates of indirect taxes. This is because at the time of the drafting of the General Agreement it was believed that without such rebates, the goods produced and sold by a country relying on indirect taxation would be higher priced, other things equal, than goods produced and sold by a country relying on direct taxes. Thus, merely because of a government's purely internal taxation practices, its exporters' ability to compete in the world markets would be impeded.

For reasons not necessarily related to these GATT rules, a number of countries (particularly the members of the European Common Market) replaced their direct corporate profit tax system with a system based on indirect taxation—the Value Added Tax (VAT) system. The switch permitted them to take advantage of the GATT rules and to rebate the tax payments on exported goods.

Almost from the beginning, however, serious doubts were cast on the basic premises from which the GATT rules concerning rebates were derived. New evidence, derived by means of improved econometric techniques, suggests that both types of taxes are actually passed on to the ultimate consumer, in effect leaving the final prices of products essentially the

same under both forms of taxation.³ This would then mean that those countries that give rebates to their exporters enable them (other things equal) to sell at lower prices than exporters in countries (such as the United States) relying on direct taxation.

The alleged discrimination against U.S. exporters, arising from special treatment of tax rebates, was apparently one of the reasons the U.S. Government chose DISCs in trying to stimulate the country's exports. Many felt that given the “in-equities” in the GATT rules concerning tax rebates, the DISC program would be less objectionable than outright export subsidies that are clearly prohibited under the GATT rules. The argument that DISCs “even the score” between the U.S. and European exporters is sometimes used today to defend the continuation of DISCs.

The validity of these arguments rests, in part, on the validity of evidence concerning the tax incidence. Until this issue is resolved, and the GATT rules changed, the United States may be in violation of the existing GATT agreement. In 1973 the Council of Ministers of the European Economic Community lodged a formal complaint with the GATT against DISCs. The GATT commission is still investigating the complaint. Should it determine that a violation of the rules exists, all GATT member nations will be authorized to impose countervailing duties on U.S. goods to compensate for the subsidy provided by the DISCs.

In a more fundamental sense, however, the validity of arguments in favor of the DISCs rests on the premise that the welfare of U.S. citizens is reduced by foreign tax subsidies, and that that loss can be restored by payment of subsidies to U.S. exporters. The analysis in this article casts serious doubts on the proposition that the welfare of U.S. citizens is in-

³Krzyzaniak, M. and Musgrave, R.A. *The Shifting of the Corporation Income Tax*. Baltimore: Johns Hopkins Press, 1963.

DISCs and the Tax Reform Act of 1976

President Ford signed the Tax Reform Act of 1976 into law as this article went to press. The act includes provisions modifying the DISC tax rules. DISCs will no longer be permitted to defer indefinitely 50 percent of taxes due on their total qualified income. Beginning with the tax year 1976 DISCs will be allowed to defer taxes on their taxable income only to the extent to which their current year's gross receipts exceed 67 percent of their average annual gross receipts over the four-year period 1972-75. The four-year base period will move

forward one year at a time, beginning with the tax year 1980. DISCs whose taxable income is \$100,000 or less will be exempt completely from this rule, while DISCs with taxable income below \$150,000 will be exempt partially.

The modification of the rules may be expected to result in a considerable reduction in tax benefits to U.S. exporters since the tax deferral will now apply only to the income derived from *increases* in their exports over the base period, rather than, as before, to their total exports.

creased by the existence of DISCs. Under these circumstances, the use of the DISCs as a vehicle of retaliation appears inappropriate.

Some concluding thoughts

The legislation establishing DISCs was adopted at the time when the traditional U.S. international trade surplus was dwindling rapidly as a result of the overvaluation of the U.S. dollar relative to the currencies of the major competitors of the United States in the world markets. Because of the key position of the U.S. dollar in the postwar monetary arrangements, the United States was believed to be unable to correct the situation by a devaluation. The DISCs appeared to be one avenue through which the country's export performance could be improved.

The two recent studies referred to in this article suggest that, at best, much doubt remains about the actual improvements that could be achieved by the DISC program, even when the recent fundamental changes in the international monetary system are not taken into consideration. The market forces unleashed by the adoption of a regime of relatively freely floating exchange rates further undermined the validity of the initial rationale for the DISCs and reinforced the doubts about the usefulness of the DISC arrangement as an efficient means toward improving the country's welfare. Finally, the dubious legality of the DISC arrangement under the existing GATT rules provides an additional argument for a careful reexamination of the DISC as a tool of national policy.

*Joseph G. Kvasnicka
Jack L. Hervey*

Do-it-yourself pensions

Tax-sheltered retirement funds of individuals, as authorized or liberalized under the Employee Retirement Income Security Act of 1974 (ERISA), exceeded \$6 billion at selected financial institutions by the end of March 1976 according to Federal Reserve Board estimates.¹ About \$1.9 billion of this represented funds in individual retirement savings plans permitted as of January 1, 1975 for employees not covered by pension plans on their jobs. The rest was accumulated under so-called Keogh plans, designed for the self-employed and their employees. Keogh plans were authorized in 1962, but the maximum amount of tax-deductible contributions was tripled under ERISA.

Retirement plan funds, because they are inherently long term and have a stable growth potential, are especially attractive to financial intermediaries. The available data indicate that funds in individual plans are held largely in the form of time and savings deposits, while only a small portion of Keogh plan funds is in this form. To qualify for the tax-exempt status, contributions under both plans are closely constrained with respect to eligible in-

dividuals, maximum amount, form of investment, and payout provisions. But the process of implementation has raised questions about certain aspects of these rules, some of which have not been finalized, and it seems likely that there will be efforts to redress apparent inequities. How these issues are resolved will have some bearing on the investment distribution of retirement-related savings flows, which seem certain to grow large in the future.

What the law allows

Pension legislation in 1942 encouraged corporate employers to voluntarily establish private pension plans for their employees as a supplement to the social security system. The legislation offered substantial tax benefits for qualifying plans. Since then the private pension system has grown rapidly, and qualified corporate plans currently cover about 36 million employees, almost three-fifths of the private nonagricultural workers.

Tax deferral for retirement savings was extended to self-employed individuals in 1962 when they were permitted to set up tax-sheltered retirement plans for themselves and their employees on a limited basis (Keogh plans). Funding was primarily through trusts established with a bank as trustee or through the purchase of annuity contracts from insurance companies. Custodial accounts were permitted if the custodian were a bank and the funds were invested in an open-end mutual fund or were used to purchase an annuity, an endowment, or an eligible life insurance contract.

¹These estimates were based on surveys conducted by the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board for depository institutions; and on information provided by the Institute of Life Insurance on life insurance and annuities, the Investment Company Institute for mutual funds, and the U.S. Department of the Treasury for retirement bonds. Accounts reported by commercial banks were those in the form of time and savings deposits. Any tax deferred retirement funds administered by trust departments were excluded, as were accounts in state-insured mutual savings banks.

Pension reform legislation in 1974 (ERISA) permitted an individual employee not covered by a qualified pension plan to defer taxes on a modest amount of savings from earned income in an individual retirement plan, allowed self-employed individuals participating in Keogh plans to substantially increase their maximum deductible contribution, and offered additional methods for establishing and funding retirement savings plans. Although individual plans are similar to Keogh plans, they are operated under somewhat different rules, the most obvious being the maximum annual contribution. Regulations, model plans, and reporting requirements have been developed and issued by the Internal Revenue Service. Subject to these separate rules, financial institutions can offer plans on a competitive basis to attract funds of eligible individuals.

Self-employed individuals. Keogh plans (also called H.R.10 plans) were first authorized by Congress in 1962 by the Smathers-Keogh Act—the Self-Employed Individuals Retirement Act of 1962—as a way for self-employed individuals, including partners, to establish tax-qualified retirement plans. Contributions to a qualified Keogh plan by a self-employed individual for himself and for his employees may be deducted from income within specified limits, and earnings on assets in the plan are tax free. Taxes are paid by the participants on income received from the plan upon retirement, when the recipients are usually in a lower tax rate bracket. Under ERISA the maximum deductible contribution for self-employed individuals was increased from 10 percent of earned income, not to exceed \$2,500, to 15 percent of earned income, not to exceed \$7,500 for 1975. In any event, all earned income up to \$750 is eligible as a deductible contribution. Whatever his own contribution relative to his earned income, the employer must contribute an equal percentage of

each eligible employee's salary.

Additional voluntary contributions may be made by each participant—employer and employees—up to 10 percent of earned income to a maximum of \$2,500 if at least one employee is covered by the plan. Voluntary additions may be withdrawn at any time without penalty although the earnings thereon can be taken only when normal benefits are paid.

Benefits are paid upon retirement (but not before age 59½ or later than age 70½), upon permanent disability, or upon death. Premature distributions are subject to a 10 percent tax on the distribution in addition to the income tax.

Recent legislation also liberalized the funding requirements for a Keogh plan. Custodial accounts may be used as qualified trusts, and federally insured credit unions and persons satisfactory to the Secretary of Treasury may act as trustees or custodians of accounts. Investment of all or part of a plan's assets in deposits at a reasonable rate of interest in a bank or similar financial institution that is the plan's fiduciary was expressly permitted if authorized by the plan or by another designated fiduciary.

Individual employees. ERISA extended limited tax deferral benefits to retirement savings of individual employees not covered by a qualified employer or a governmental pension plan, or a tax-sheltered annuity plan of certain tax-exempt organizations. Up to 15 percent of annual earned income to a maximum of \$1,500 may be paid into a qualified individual retirement savings plan by the individual, by the employer, or by the employee's union. The contribution may be deducted by the individual from gross income. The individual retirement savings plan may be based on an individual retirement account, an individual retirement annuity, or special retirement bonds.

A qualified individual retirement account (IRA) must be a trust or a custodial

account with a bank, a savings and loan association (S&L), a federally insured credit union, or another person approved by the Secretary of Treasury as trustee or custodian. An employer or union may establish a group IRA for its employees or members, but there must be separate accounting for the interest of each individual participant. Assets of an IRA may be invested at the direction of the individual in conventional savings accounts or common trust funds or common investment funds. To date most depository institutions have offered only conventional savings instruments pending clarification of Security and Exchange Commission registration requirements.

The individual may use the permissible savings deduction to purchase an individual retirement annuity contract, a joint and survivor annuity contract for the benefit of the individual and spouse, or an endowment policy from an insurance company. The contract must be nontransferable and may not be used as security for a loan.

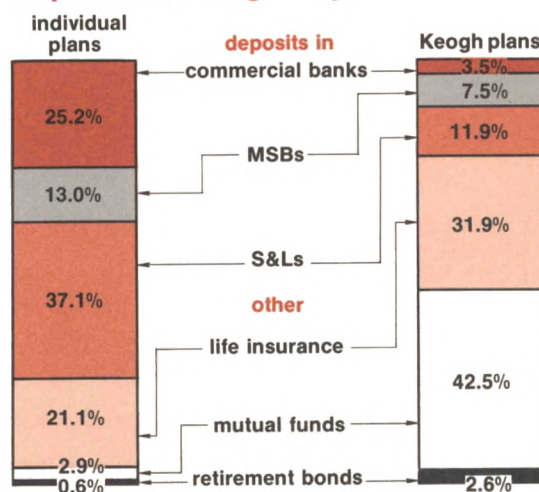
As in Keogh plans, retirement benefits to the individual participating in an IRA or an annuity may begin as early as 59½ years of age and must start when he reaches 70½ years of age. The benefits are taxable income in the year received. Premature distributions, except for death or disability, are subject to an additional tax of 10 percent on the amount of the distribution.

Only the fraction of the premium for a life insurance endowment policy which is allocable to the retirement savings aspect of the policy is eligible as a deduction for savings. Distributions from qualified endowment contracts are taxed as ordinary income to the extent allocable to retirement savings and as life insurance proceeds to the extent allocable to life insurance. The contract must mature no later than the taxable year in which the individual becomes 70½ years of age. At maturity the full cash

surrender value constitutes retirement savings, and all amounts payable are taxed as ordinary income.

Retirement savings invested in special U.S. Individual Retirement Bonds are also eligible for deduction from gross income. The special bonds mature when the registered owner reaches 70½ years of age or five years after the date of his death, whichever is earlier. Interest is earned at 6 percent per annum, compounded semiannually, and is paid upon redemption of the bonds. The bonds are issued only in registered form and in denominations of \$50, \$100, and \$500. They are not transferable and may not be pledged as collateral for a loan. The bonds may be redeemed during the first 12 months of issue date without penalty and without interest. Beyond that period, redemption prior to age 59½, except for disability or death, entails a penalty payment of 10 percent of the face value of the bond in addition to ordinary income tax on the amount.

Distribution of the dollar volume of funds in the two types of plans differs greatly



Source: Estimated by the Federal Reserve Board. Excludes bank common trust funds and accounts in state-insured MSBs.

Market shares

The results of the March 31, 1976 surveys of the regulatory agencies show that funds paid into qualified individual retirement savings plans have followed a very different investment pattern than those in Keogh plans, where mutual funds and life insurance account for almost three-fourths of the reported totals. (See chart.) Tax deferred individual retirement funds, by contrast, are predominantly in IRAs invested in time and savings deposits at banks and savings and loan associations.

This difference has been attributed in part to earlier restrictions and to less aggressive competition on the part of depository institutions in the development of Keoghs, but it also reflects the larger contributions permitted under Keogh plans and perhaps the greater financial sophistication of the self-employed. Savings and time deposits are a more likely outlet for relatively small sums of money. According to the surveys the average amount of IRA funds invested in time and savings deposits was \$1,661 at commercial banks and \$1,561 at mutual savings banks (MSBs), with little variation by the size of the bank. The maximum amount that could be saved in an account during 1975 was \$1,500. This suggests that most individuals who have established such accounts earned incomes in excess of \$10,000 a year and are saving the maximum amount.

S&Ls account for about one-half of the funds of IRAs and Keogh plans that are in depository form. Commercial banks have about one-third of IRA funds but only 15 percent of Keogh plan funds in time and savings deposits.

The relatively small amount of Keogh plan funds in deposit form reflects the fact that many depository institutions, especially the smaller ones, do not have such accounts. (See table.)

About half of the mutual savings banks and savings and loan associations reported having Keogh accounts, including almost all of the larger institutions. Only 15 percent of insured commercial banks had Keogh plan funds in

IRAs are more common than Keogh savings accounts at depository institutions, regardless of size

Deposit size (million dollars)	Commercial banks		Savings and loan associations		Mutual savings banks	
	Keogh	IRA	Keogh	IRA	Keogh	IRA
(percent reporting accounts)						
Less than 10	7	42	19	51	0	11
10 - 50	15	72	42	77	27	74
50 - 100	30	85	67	89	43	88
100 and over	38	87	86	94	77	96
Total	15	63	49	77	55	87

Note: Federally insured institutions.

time and savings deposits. Even among the banks with total deposits of \$500 million or more, less than half reported Keogh plan funds in savings deposits.

The more aggressive promotion of savings deposits for Keogh plan funds by mutual savings banks than by commercial banks may be reflected in the smaller proportion of funds held in regular savings accounts at mutual savings banks. Only 9 percent of Keogh funds are in savings accounts with a ceiling rate of 5.25 percent at federally insured mutual savings banks, but one-fourth of such funds are in savings accounts with a ceiling rate of 5 percent at commercial banks. (Comparable data are not available for S&Ls.)

Although IRAs have been authorized only since January 1975, \$1.4 billion was

outstanding at depository institutions 15 months later. About one-half of this was at savings and loan associations, one-third at commercial banks, and one-sixth at mutual savings banks.

The proportion of institutions reporting IRAs rose as the deposit size increased. Thus 87 percent of the commercial banks, 94 percent of the savings and loan associations, and 96 percent of the mutual savings banks with total deposits of \$100 million or more had IRA funds.

Long-term money

Savings placed in individual retirement plans are particularly attractive to depository institutions, mutual funds, and insurance companies because these funds are relatively long term and less subject to disintermediation during periods of rising market interest rates. Withdrawals of the funds except for death, disability, retirement, or transfer to another retirement account is subject to penalty. Moreover, withdrawals are gradual and predictable.

Competition among depository institutions for IRAs has been accompanied by promotion of longer-term time deposits on which higher interest rates can be paid. Only 11 percent of IRA funds were in regular savings accounts at commercial banks, while 52 percent of IRA funds were in time deposits with maturities of six years and over and a ceiling rate of 7½ percent. At mutual savings banks only 6 percent of IRA funds were in regular savings accounts and 57 percent in time deposits with a maturity of six years and over.

Regulation Q of the Federal Reserve Board and equivalent rules of other supervisory agencies governing maximum interest rates payable on time deposits of various maturities were amended effective December 4, 1975 to accommodate IRAs. Member banks are permitted to pay all or a portion of a retirement account time deposit prior to its maturity, without penal-

ty for early withdrawal, when the individual is 59½ years of age or more or becomes disabled. Early withdrawal from time deposits without penalty upon death of the depositor was already permitted. In addition, IRAs could be established for less than the \$1,000 minimum required for time deposits with four- to six-year maturities. In effect, the amendments permitted the maximum rate of 7½ percent to be paid on all IRAs at commercial banks. The maximum rate at MSBs and S&Ls is 7¾ percent.

Interest rate differential

The establishment of IRAs by eligible individuals has required a review of regulations for time and savings deposits at depository institutions. Previously, all savings at depository institutions had been from income on which income taxes had been paid without concern for the purpose of the savings. Ceiling rates on interest paid and penalties for early withdrawal of time deposits have been imposed to prevent destructive rate competition among depository institutions, to control withdrawals, and to maintain savings flows for preferred investments, particularly housing.

Elimination of the existing differential in rate ceilings payable by commercial banks and by S&Ls and MSBs continues under study. Commercial banks contend that the ¼ percent lower maximum rate they pay on time and savings deposits has hindered their ability to compete for IRAs and substantially reduces the earnings of the saver over the long term. S&Ls and MSBs claim that the higher maximum rate is necessary for them to attract and retain savings for investment in housing because they are not permitted to offer a full line of financial services. Any action by the Federal Reserve Board of Governors to eliminate or reduce an interest rate differential for any category of deposits or

accounts that was in effect on December 10, 1975 must be approved by concurrent resolution of the House of Representatives and the Senate. A recommendation on this issue by the FRB to Congress is expected in early 1977 in connection with Congressional consideration of extension of the Board's authority to establish interest rate ceilings for member banks.

Other unresolved problems

Clarification of required SEC registration has delayed the offering of common trust or investment funds as an alternative investment vehicle for IRA funds by depository institutions. Under ERISA the assets of an IRA may be invested in a common trust fund or investment fund for the purpose of diversifying investments, as is permitted for assets of Keogh plans. The legislation, however, did not limit the authority of the SEC in the application of federal securities laws to IRAs or to common trusts or investment funds maintained by an institution for the investment of IRA assets.

Pension rights are not fully portable. The extension of tax deferral to retirement savings plans of individuals provided a method for partial portability of pension rights. Money or property may be distributed from a tax-qualified plan as a lump sum or from an individual retirement account to the plan's participant on a tax-free basis if the same money or property (excluding the employee's contribution of after-tax income) is reinvested by the participant within 60 days in a qualifying individual retirement account, i.e., rolled over. Eligible amounts received from a qualified plan may also be transferred to the qualified plan of the individual's new employer with the consent of the new employer. But unless the individual's pension benefits are vested, funds eligible for tax-free rollover from qualified employer-sponsored plans are limited to the earnings on the employee's contributions. Tax-free

rollovers between individual retirement accounts may occur only once every three years.

Finally, ERISA, as it now stands, entails some inequities and inadequacies. It does not permit an individual who, under a qualified plan, may be accruing pension benefits which are not vested to establish a tax deferred individual retirement plan. If an employee transfers to another employer prior to vesting of the pension rights, the individual will not only forfeit accrued pension benefits but will also not be allowed tax deferral for retirement savings when accruing those benefits. Similarly, legislation does not provide for tax deferral on supplemental retirement savings when vested benefits under a qualified plan are inadequate. Nor does it allow an additional level of tax shelter for those already near retirement age when the law was passed.

Recent tax reform act

The Tax Reform Act of 1976, signed on October 4, 1976, expanded the number of individuals who may be covered under qualified individual retirement savings plans. Beginning in 1977, an employee who is eligible to set up an individual retirement plan and who has a non-employed spouse may set up separate equal accounts for self and spouse or one account with equal subaccounts with the right of survivorship. A total of 15 percent of earned income or \$1,750, whichever is less, may be contributed to the accounts and deducted from gross income each year.

The new tax law also permits members of the Armed Forces Reserves and the National Guard who are covered by the military retirement plan to qualify for a private retirement savings deduction. Effective in 1976, a member with 90 or fewer days of active duty during the year (other than for training) who is otherwise eligible will be permitted the deduction.

Eleanor Erdevig

