IRET Byline

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Bentsen's IRA Leads Middle-Income Savers Down A Primrose Path

Senate Finance Committee Chairman Lloyd Bentsen must have thought he would score points with voters by introducing a proposal to expand tax benefits for Individual Retirement Accounts (IRAs). His expressed interest in reducing tax barriers to individuals' saving is highly commendable. But that's where the kudos stop.

Sen. Bentsen offers his IRA proposal as an alternative to a capital gains tax reduction. His proposal to restore a 50 percent tax deduction for IRA contributions, he says, would be more of a benefit to middle-income individuals than a capital gains tax reduction. He is, unfortunately, mistaken.

A capital gains rate reduction, he asserts, would be a windfall mostly for the rich and would be a revenue loser for the government. Bentsen says his IRA proposal, on the other hand, would help lower interest rates, spur greater economic growth, and enhance American competitiveness. It is highly regrettable that Sen. Bentsen can't perceive that a capital gains tax reduction is also needed to accomplish those ends.

If the Senator's purpose is to encourage greater savings and investment, he must realize that the current tax treatment of capital gains is a severe barrier to private saving. The tax on capital gains is an additional layer of tax on the rewards for saving, making it more expensive to save and invest. The ideal capital gains tax rate is zero. Lowering the current rate, however, would have the same effect of easing the tax bias against saving that Sen. Bentsen hopes to achieve with his IRA proposal. It would encourage investors to unlock their assets and invest in new, innovative ventures. A lower capital gains rate would also lessen the tax bias against equity financing. The result: increased employment, productivity, economic growth, and global competitiveness. Sen. Bentsen's IRA proposal, on the other hand, would increase rather than reduce the excessive tax burden on saving. In exchange for the benefit of a current tax deduction for a limited amount of saving, many investors in Sen. Bentsen's IRAs would pay an exorbitant amount of tax on these savings and the interest they've earned when they are withdrawn.

As long as the Medicare catastrophic surtax and the taxation of up to half of Social Security benefits remain in the law, taxable post-retirement earnings are very often subject to marginal tax rates much higher than the 15 percent, 28 percent, or even 33 percent income tax rates. Millions of middle-income savers will find themselves in tax brackets as high as 28.8 percent and 53.7 percent when they make withdrawals from their IRAs for their golden years. Unless the catastrophic surtax and the income tax on Social Security benefits are repealed, the Bentsen proposal will be a bad deal for middle-income savers.

The jump in tax rates on investment income that retirees face because of the catastrophic surtax and the income tax on up to half of Social Security benefits defeats the purpose of IRAs. The only people who would benefit from Bentsen's IRA are well-to-do individuals whose retirement incomes will be so high that they will pay the maximum amount of catastrophic surtax and income tax on half of their Social Security benefits. These people fare marginal tax rates at the normal levels. The Bentsen proposal sets up retirees with lower incomes for stunning and punitive tax surprises.

On the other hand, there are millions of middle-income taxpayers who would benefit from a capital gains tax rate reduction. If either bill favors the rich more than the middle-income population, it is most definitely Sen. Bentsen's IRA proposal.

Although Sen. Bentsen surely does not intend to mislead the public, he should promptly get a grip on his tax policy agenda and modify his position on capital gains. After all, it was Mr. Bentsen who warned that elimination of preferential treatment of capital gains and IRAs would discourage savings and penalize U.S. global competitiveness. Good tax law, as Sen. Bentsen knows, requires a cut in capital gains and a tax-deferred IRA.

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