U.S. Senate Republican Policy Committee
Established 1947

May 1, 2003

‘A Nation of Owners and Savers’

Executive Summary

According to the 2003 Social Security Trustees’ Report, Social Security payroll taxes will be unable to fund full benefits in only 15 years. Social Security must find new sources of financing if full benefits are to continue to be paid after 2018. Fortunately, the President’s Commission to Strengthen Social Security provided direction as to how Congress could not only avert that looming crisis, but also help transform America into “a nation of owners and savers.”

This paper explains the importance of reforming the current Social Security system to include personal retirement accounts that could allow all Americans to accumulate real wealth for themselves and their children. Instead of simply transferring income between generations, as is currently the case, a reformed Social Security program could allow the average worker to build an estate using a portion of his payroll taxes.

The late Senator Daniel Patrick Moynihan was as interested in how Social Security could be “improved” as he was in saving it from financial collapse. Propelled by his belief that Americans should “acquire wealth as part of social insurance,” Senator Moynihan in 2000 proposed Social Security reform legislation to provide personal retirement accounts, and a year later co-chaired President Bush’s Commission to Strengthen Social Security.

The release of the Federal Reserve Board of Governors’ “Survey of Consumer Finances” this past February has made Social Security reform based on Senator Moynihan’s vision more urgent. The Fed study found that far too few Americans, particularly in the African American community, own financial assets of any sort and that the “wealth gap” between the median white and African American family widened by nearly 18 percent between 1998 and 2001.

As the Fed study makes clear, the wealth gap cannot be explained by income alone, as the income gap between races actually narrowed during the same period. The problem is a relative lack of investment, particularly in stocks, on the part of African Americans. Social Security reform, which includes the opportunity to invest in personal accounts, would address this problem directly by eliminating the features of the current system that restrict saving and, instead, help create the system envisioned by Senator Moynihan where the benefits of wealth accumulation could be enjoyed by all in society.

Introduction

In a career of public service that spanned over four decades and nine Presidents, Senator Daniel Patrick Moynihan was never afraid to pursue policies he believed to be in the nation's interest, even if they clashed with the orthodoxies of his own party. In his last official capacity, Senator Moynihan served as co-chairman of President Bush's Commission to Strengthen Social Security.

Although the public policy discourse concerning Social Security typically centers on the program's precarious financial footing, as was often the case, Senator Moynihan's approach was more probing. While it is true that Senator Moynihan cited the program's looming cash-flow deficiency as the impetus for swift action, it was the "marvelous idea" that the system's transformation could create a "nation of owners and savers" that Senator Moynihan found most compelling.[1]

Senator Moynihan recognized that complementing Social Security with a savings component would actually revolutionize the program by redefining its purpose. Instead of simply maintaining income for retirees, Moynihan said, "we propose something beyond: an estate! For doormen, as well as those living in the duplexes above."[2]

A rededicated Social Security program to provide all Americans with the means of building an estate would not only improve the financial circumstance of retirees, but also improve the lives of their children. "Wealth produces assets that live on, independent of the individual," Moynihan wrote. "It can be used to nurture children for whatever success is said to require, be it tuition or orthodontia. Wealth is an insurance policy that gives not only physical but psychological comfort."[3]

Unfortunately, today too many children grow up without the "insurance policy" wealth provides. As Democratic Commission member Sam Beard has said, "I sit afraid that we're becoming two separate societies. One of the big dividing points is between those with financial assets and those without. Half of American society has less than 2 percent of the financial assets, that's unacceptable."[4]

Yet in its current form, Social Security does more to impair wealth accumulation than to advance it. As the commission's Interim Report states, "if savings options are not created within Social Security, these families may lose their best chance to acquire financial assets."[5] And ownership of financial assets is the only real way to build an estate and financial security.

---

[1] Sen. Moynihan quoted in transcript of June 11, 2001 meeting of the President's Commission to Strengthen Social Security, p. 9.
[2] Sen. Daniel Patrick Moynihan, "Building Wealth for Everyone," *The New York Times*, May 30, 2000.
[3] Sen. Daniel Patrick Moynihan, "Half the Nation's Children: Born Without a Fair Chance," *The New York Times*, September 25, 1988.
[4] Beard, Samuel, The President's Commission to Strengthen Social Security, *Opening Statement*, read at the June 11, 2001 commission hearing.
[5] The President's Commission Interim Report, p. 6.

The implications of this problem are particularly acute for African Americans, according to Senator Moynihan, because so many – nearly half – "have no financial assets of any kind."[6] As fellow Democratic Commission member Robert Johnson said, "African Americans die earlier, therefore receiving less in the form of Social Security payouts. One of the ways to address this is through the use of wealth-generating private accounts that form part of an estate opportunity for African Americans."[7]

When the commission released its report, Senator Moynihan commented: "This is the first time that a national panel has unanimously proposed that Americans acquire wealth as part of social insurance."[8] Although the final report proposed three different reform proposals and hundreds of pages of supplementary findings, the whole commission agreed on one point: "the time to include personal accounts in (Social Security) has indeed arrived."[9]

Wealth accumulation facilitated through the oldest and most widely appreciated program of the welfare state is necessary to address the inequality in wealth that continues unabated. African Americans continue to have far less wealth than their white counterparts, and this divergence in fortune shows no signs of reversing itself, even in the face of more even incomes between races. Social Security reform based on personal accounts remains the best hope to narrow the wealth gap and expand the benefits of wealth to all in society.

New Data Reveal the Urgent Need to Act

A three-year study released this past February by the Federal Reserve Board of Governors reveals a "good news-bad news" financial picture: the good news is that the "income gap" between white American and African American households is closing; the bad news is that the "wealth gap" continues to widen. The data from the Fed's "Survey of Consumer Finances" (SCF), collected between 1998 and 2001, suggest that the disparity between income and wealth is caused by African American households' relative lack of investment in financial assets, particularly stocks.

Although some believe that the wealth gap could be explained solely by income disparities, the Fed data makes clear that there is more to the picture than that: African Americans are much less likely to invest in stocks (when stock mutual funds are included) than whites at *all* levels of income. As long as African Americans invest less in wealth-generating assets, such as stocks, mutual funds, and bonds, income growth alone will not close the wealth gap between races.

[6] Moynihan quoted in "Commission Offers Three Options to Modify Social Security," *The San Francisco Chronicle*, December 12, 2001.
[7] Robert Johnson quoted by President George W. Bush. Remarks to the National Summit on Retirement Savings, *Public Papers of the Presidents*, March 4, 2002.
[8] Moynihan in *SF Chronicle*.
[9] The President's Commission Final Report, p. 9.

Household Financial Wealth Explained

As economists recognize, the relationship between household income and household wealth is nonlinear.[10] This is to say that at a certain point in the income distribution, each dollar of additional income is likely to result in more than one dollar of additional wealth. The reason for this is simple: higher-income households typically invest a greater percentage of their income, resulting in a faster rate of asset accumulation.[11] In addition, owning more assets results in greater wealth accumulation as the value of those assets increases, as is typically the case with corporate equities and other securities over a sufficient time horizon.

Adding the total value of the assets owned by a household and subtracting its liabilities results in a household's net worth.[12] According to Fed data, median U.S. household net worth (the net worth of a family in the middle of the wealth distribution) increased from $61,300 in 1992 to $86,100 in 2001, an increase of 40.5 percent. The *average* net worth of American families (total household wealth divided by total U.S. households) grew by an even more impressive 71.6 percent – to $395,500 – during the same period.[13]

The main reason for the dramatic increases in household net worth during the last decade was changes in portfolio composition. The percentage of household savings held in checking accounts decreased by 34 percent during the period, while the percentage of savings in stocks and mutual funds increased by 40.2 percent.[14] Households shunned poor-performing assets in the past decade, including certificates of deposit (CDs) (down 61.2 percent), savings, municipal and sovereign bonds (down 44.2 percent), and life insurance (down 10.1 percent), in favor of retirement accounts (up 10.5 percent) and other managed assets (up 96.3 percent), including trusts and private annuities, both of which were weighted heavily towards stocks.[15]

Overall, financial assets as a share of total household assets increased from 31.6 percent in 1992 to 42 percent in 2001.[16] This dramatic portfolio reallocation was a direct product of the booming stock market of the 1990s. During the period, the Dow Jones Industrial Average increased by 210 percent, while the broad-based S&P 500 increased by 181 percent.[17] As the stock market boomed, household stock holdings increased in value relative to other assets, which increased the weight of stocks in household portfolios and boosted incentives to devote an even greater percentage of savings towards stocks.[18]

---

[10] Robert Barsky, John Bound, Charles Kerwin Kofi, and Joseph P. Lupton, "Accounting for the Black-White Wealth Gap: A Nonparametric Approach," *Journal of the American Statistical Association* (No. 459, Vol. 97), September 1, 2002, pp. 663-664.
[11] Barsky et al., p. 664.
[12] Federal Reserve, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," Federal Reserve Bulletin, January 2003, p. 6.
[13] Federal Reserve., p. 6-7.
[14] Federal Reserve.
[15] Federal Reserve.
[16] Federal Reserve.
[17] Figures available using "Historical Prices" feature at http://finance.yahoo.com/.
[18] Although the percentage of personal income saved declined during the period, owing to the oft-cited "wealth effect," these figures deal with portfolio composition. For information concerning the relationship between appreciating assets and household savings rates see: Brian Cashell, "The Falling Personal Savings Rate and Its Economic Implications," CRS Report for Congress, July 31, 2002.

During a period of equity price appreciation, the growth of family net worth is closely correlated to the family's investment in corporate equities. And even when equities are not experiencing historic records, as they were in the 1990s, equities remain the most reliable source for long-run wealth accumulation.[19] Even if household net worth were readjusted to account for the stock market declines of 2002, median household net worth would only be 6.3 percent lower than observed in the 2001 SCF.[20]

African American Household Wealth

The role of corporate equities in wealth accumulation helps explain the "wealth gap" between white and African American households. As numerous academic studies have found, the rate of wealth accumulation of black households is significantly below that of white households.[21] While econometric models have proven that wealth accumulation is positively correlated with income, education, and consumer age, those same variables are unable to explain the racial wealth gap.[22]

According to Fed data, between 1998 and 2001, African American median household income grew by 20 percent, compared to only 10 percent for whites,[23] and the overall ***income gap decreased*** by about one percent.[24] At the same time, the gap between the median ***net worth*** of African American households and that of white households ***increased*** by nearly 18 percent.[25] Depending on which data sets are used, white households now hold between five to ten times as much wealth as black households but earn only twice as much.[26]

Many economists and sociologists have tried to explain why the wealth gap persists as the income gap narrows. Some econometric studies have examined such possible variables as marriages between couples of the same versus dissimilar financial background, inheritability of skills, stability of marriage, and fertility patterns to explain differences in wealth accumulation.[27] While models based on these variables have been able to account for *intra-racial* wealth disparities, none has been able to explain adequately the racial gap in wealth.

In the studies surveyed, the only enduring explanation for the gap, "*when holding income constant*," is the "apparent difference by race in the propensity to hold different types of wealth-generating assets, such as housing and stocks."[28]

---

[19] Martin Feldstein, "Privatizing Social Security: The $10 Trillion Opportunity," CATO Institute Social Security Papers, No. 7, January 31, 1997.
[20] Federal Reserve, p. 7.
[21] D. Anthony Plath and Thomas H. Stevenson, "Financial Services and the African-American Market," Financial Services Review Vol. 9, No. 4, 2001, pp. 344-345.
[22] Plath and Stevenson.
[23] Federal Reserve, p. 5
[24] Federal Reserve, p. 5-8.
[25] Federal Reserve.
[26] Barsky et al. pp. 663-664.
[27] See Section II, Related Literature, contained in Jagadeesh Gokhale, Lawrence H. Kotlikoff, James Sefton, and Martin Weale, "Simulating the Transmission of Wealth Inequity Via Bequests." National Bureau of Economic Research, Working Paper 7183, June 1999, p. 1.
[28] Barsky et al, p. 674.

For example, according to Fed data, African Americans are much less likely than are whites to hold corporate equities ***at every income level*** when mutual funds are included:

- For those making between $25,000 and $49,999, 19 percent of whites own stock, with an average holding of $9,009; meanwhile, 12 percent of blacks in this income group own stock, worth an average of $1,160.[29]

- For those with incomes in the $50,000-to-$100,000 range, 29 percent of whites own stock, with an average value of $22,259 compared to 14 percent of blacks, with a $6,893 average.[30]

- And for those in the $100,000-and-above income group, black households are ***more*** likely to own stock than white households (62 percent versus 56 percent), but whites making over $100,000 are much more likely to own a stock mutual fund (44 percent versus 29 percent) than their black counterparts. For families with incomes over $100,000, the size of the average white stock holding is over four times that of the average black household ($282,400 versus $54,735), while the average value of white families' stock mutual fund holdings are nearly four times that of blacks' ($81,554 versus $20,619).[31]

These trends persist regardless of education. Among heads of households who are high school graduates, 5 percent of black households own stock, with an average value of $1,086, compared to 16 percent of whites, whose average stock portfolio is worth $18,783.[32] For those who completed college, 14 percent of blacks own stock, worth an average of $2,417, versus 29 percent of whites, whose stock was worth an average of $28,720.[33]

And while employer-sponsored investment plans may exacerbate the racial difference, they demonstrate a similar propensity among African Americans. While 41 percent of whites are eligible to participate in employer-sponsored defined-contribution plans, such as 401(K)s, only 32 percent of African Americans are eligible to participate in such programs; yet among employees who have access to such programs, 68 percent of whites participate versus 53 percent of African Americans.[34]

The Effect of Differing Investment Rates on the Wealth Gap

The relative lack of stocks in African Americans' portfolios has a profound and quantifiable effect on the wealth gap between races. A recent study by economist Edward Wolff suggests that if African American households had the same portfolio composition as did white households between 1984 and 1994, the wealth gap would have been narrowed by six to eight percentage points.[35] Moreover, Wolff reaffirms the belief that "periods of asset price increases

---

[29] Plath and Stevenson, p. 349.
[30] Plath and Stevenson.
[31] Plath and Stevenson.
[32] Plath and Stevenson, p. 351.
[33] Plath and Stevenson.
[34] Michael Tanner, "Disparate Impact: Social Security and African Americans." CATO Institute Briefing Papers, no. 61, February 5, 2001.
[35] Edward N. Wolff, "Racial Wealth Disparities: Is the Gap Closing?" The Levy Economics Institute of Bard College, Public Policy Brief No. 66 (2001), p. 24.

pushes[sic] up the overall rate of return on capital for whites relative to African Americans because of the greater weight of stocks in the former group's portfolio."[36]

Using a completely different set of data, Ohio State sociologist Lisa Keister reached similar conclusions. Her study simulated the effect on the distribution of wealth if blacks had invested in stocks and stock mutual funds at the same rates as whites between 1960-1995, with all other variables held constant. Under this scenario, the wealthiest one percent of Americans in 1995 would have held 31 percent of the nation's total wealth, 8 percent less than the actual figure of 39 percent, with African Americans making up 5 percent of the wealthiest households.[37] According to Keister, "much of the existing wealth disparities could be alleviated by policies that encourage blacks to own high-risk assets such as stocks."[38]

In recognition of these challenges, Black Entertainment Television (BET) and the Consumer Federation of America (CFA) last August launched a "Black America Saves" initiative to provide African Americans with free information about savings and investment strategies and free access to financial planners via phone or the Internet.[39] This program will supplement the NAACP's "Financial Empowerment Initiative," which seeks to promote "financial literacy, personal investing, small business development, and homeownership" in the African American community.[40]

Social Security and the Wealth Gap

Based on Federal Reserve data, it is clear that if the wealth gap is ever to be closed, African Americans must invest in financial assets to a far greater extent. One solution to closing the wealth gap then seems apparent: adopt policies that encourage blacks to invest more in the stock market and other financial assets. How can government do this? One way is Social Security reform that allows workers to invest in assets, such as stocks. This policy speaks to the work of Professor Keister and could be the perfect complement to the efforts of the NAACP, BET, and CFA.

As the following sections will demonstrate, Social Security has evolved since its implementation to extract more resources from workers for far less in return. This has negatively affected blacks relative to whites because of blacks' shorter life expectancy and lower median income. Instead of addressing future cash-flow shortfalls with further payroll tax increases that will only exacerbate the wealth gap, Congress should consider changing Social Security's retirement benefit component from its current "longevity insurance" model to one based, at least in part, on personal savings and retirement accounts.

---

[36] Wolff, p. 26.
[37] Keister, Lisa, "Race and Wealth Inequality: The Impact of Racial Differences in Asset Ownership on the Distribution of Household Wealth," *Social Science Research,* December 2000, Vol. 29, Issue 4, pp. 477-502.
[38] Keister.
[39] See press release announcing the initiative at: http://www.consumerfed.org/blacksavespr.html.
[40] See the NAACP's Financial Empowerment Initiative at http://www.naacp.org/work/fei/fei.shtml.

Demographics and Social Security's Transformation

Social Security was enacted in 1935 to "give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age."[41] The central part of the program, Old-Age Survivors Insurance (OASI), was intended to provide direct cash assistance to seniors, most of whom lived in poverty.[42] Although life expectancy at birth was 56.6 years for men and 60.6 years for women when Social Security cards were first issued, benefit payments did not begin until age 65.[43] The disparity between life expectancy and the eligibility age at the time of enactment illustrates that Social Security was not designed to serve as a retirement plan, but to provide longevity insurance for those who had lived beyond the age at which they could generate employment income of their own.

However, longer U.S. life expectancy has fundamentally transformed the program from a longevity insurance program with low up-front costs (payroll taxes) and few beneficiaries to a *federally enforced retirement-savings program* with high up-front costs and many beneficiaries. The tax burden necessary to finance all Social Security benefits, which has risen from 0.7 percent of GDP immediately after Social Security's enactment to 4.5 percent of GDP today,[44] reflects this transformation. Social Security taxes now amount to one-third of all Federal revenues and Social Security benefits account for about 42 percent of all income going to the elderly.[45]

Social Security as a Retirement Program: A Square Peg for a Round Hole

To understand how longevity insurance differs from a retirement savings program, one need only recognize that if Social Security were to be implemented today on the same terms as it was in 1936, the OASI eligibility age would be 85.[46] Individuals wishing to retire prior to that age would have to save during their working lives to accumulate the resources necessary to do so.

Thus, because the payout of benefits would be limited to those Americans who had lived longer than could be expected, the OASI tax contributions necessary to keep the program actuarially sound would be a fraction of what they are today, and the entire system's premiums and payout would again resemble a traditional insurance program. This paper does not recommend a delay in benefit payments, but illustrates the logic of doing so if Social Security were to maintain its current structure.

Traditional insurance markets provide an affordable mechanism by which risk can be spread over an entire community. For example, homeowners' insurance protects families from financial hardship wrought by an unexpected event, such as a fire or burglary. For the market to work efficiently, most families will pay insurance premiums for many years and receive nothing

---

[41] Statement of President Franklin D. Roosevelt upon signing the Social Security Act, August 14, 1935.
[42] Social Security Administration, "Mission and Impact of the Social Security Administration," www.ssa.gov/finance/97impact.pdf.
[43] Center for Disease Control and Prevention, "Estimated Life Expectancy at Birth," National Vital Statistics Report [Vol. 50, No. 6], March 21, 2002.
[44] Budget of the United States Government, fiscal year 2003, Historical Table 2.4: Composition of Social Insurance Taxes 1940-2007.
[45] Julia Lynn Coronado, Don Fullerton, and Thomas Glass, "The Progressivity of Social Security," National Bureau of Economic Research Working Paper 7520, February 2000, p. 2.
[46] Calculated from the CDC Vital Statistics Report using the relationship between life expectancy at birth and OASI eligibility in 1936 to estimate the hypothetical eligibility age in 2003 based on today's life expectancy at birth.

from the insurance company in return. But their premium payments will provide the financial base that the insurer will use to pay the claims of a small subset of families who endure an incident that triggers an indemnity payment.

When life expectancy at birth was 60, providing an indemnity payment for the few lucky enough to reach age 65 was the sort of rare event well suited for an insurance model. But as medical science has redefined the meaning of "old-age," this is no longer the case.

Social Security's Old-Age Insurance Inhibits Flexibility and Choice

Since the framers of Social Security's OASI program never intended it to function as a retirement savings plan, it should be no surprise that it performs so poorly in this role. As a practical matter, Social Security regulates the way workers save for retirement by mandating the contribution level and the retirement benefit formula. *But when compared to the ways families save for retirement when given the freedom to do so voluntarily, OASI's forced-retirement-savings plan is clearly out-of-step with current needs.*

According to Fed data, the primary reason families save is for retirement.[47] And the nation's capital markets provide a diverse range of financial products to meet this need, including corporate stocks and bonds, mutual funds, and treasury securities. While household savings decisions are influenced by many factors, including risk appetite, the state of the economy, and tax laws, the point is that families have the ability to allocate savings to pursue their financial goals.

Conversely, OASI offers its contributors no choices. It mandates that all workers must purchase a retirement annuity (OASI benefits) at a uniform price (OASI payroll taxes).[48] In 2002, the price charged for the annuity was an OASI tax rate of 10.6 percent of income up to $84,600. (The more commonly cited 12.4-percent payroll-tax rate also includes Disability Insurance (DI), which shares the same trust fund, but is a separate policy issue.) In total, OASI "contributions" in the 2002 calendar year were estimated to be $541.9 billion.[49] One-half of OASI taxes are paid by workers, and the other half paid by their employers, although most economists recognize that workers pay the full amount through reduced wages.[50]

The value of the annuity and the age at which it begins payment is also government-mandated. Monthly annuity payments are calculated using a complex benefit formula based on the worker's highest 35 years of earnings up to the OASI cap for each of those years, plus a cost-of-living adjustment. That total is then calibrated by the worker's retirement age (either 62, 67, or 70), with monthly benefits reduced for those who retire earlier and vice versa.[51] Social Security's benefit structure is progressive, as the percentage of income "replaced" by Social Security at the normal retirement age ranges from about 50 percent for workers with an indexed monthly income of $1,000 to under 30 percent for those workers earning the maximum taxable amount.[52]

---

[47] Federal Reserve, p. 6.
[48] Jeffrey Brown, "Redistribution and Insurance: Mandatory Annuitization With Mortality Heterogeneity," Center for Retirement Research at Boston College, [CRR WP 2001-02], April 2001, p. 6.
[49] Social Security Administration, 2002 Budget Fact Card.
[50] Julia Lynn Coronado et al., p. 11.
[51] Congressional Budget Office, "Social Security: A Primer," September 2001.
[52] CBO.

The Problem with Forcing Workers to Purchase Social Security Annuities

Since the most recent mortality statistics confirm that whites live six years longer than blacks, on average,[53] OASI's inflexible benefit structure should be of particular concern to policymakers troubled by the wealth gap between whites and African Americans. By maintaining its original structure as longevity insurance, Social Security's OASI effectively results in African Americans, because of their shorter life-expectancy, subsidizing whites. On a lifetime basis, whites collect $21,000 more in OASI benefits, on average, than African Americans with similar income and marital status.[54]

Longevity insurance, in the form of an annuity, protects individuals against the premature exhaustion of retirement savings, which could easily occur since no one knows how long he or she will live.[55] The longer individuals live, the greater the chances of exhausting their retirement savings, making annuitization attractive. However, for demographic groups with shorter life expectancies, longevity insurance is less appealing.

For example, an analysis conducted by Jeffrey Brown for the Center for Retirement Research at Boston College found that while, on average, a college-educated white male would derive the most utility from converting 92 percent of his retirement savings into an annuity, "an African American male with less than a high school education would, on average, be best served to annuitize only 69 percent of his retirement savings."[56]

Unfortunately, Social Security's inflexible structure does not allow individual workers to tailor the system to their needs, and the average African American suffers as a result. This is demonstrated by a common valuation tool, called the "money's worth measure," simply defined as the present value of an annuity payment (Social Security check) per dollar spent to purchase the annuity (each dollar of OASI taxes). The value of each dollar deducted in payroll taxes from the salary of a black male who failed to complete high school is, on average, worth only 80 cents. Conversely, the value of each payroll-tax dollar taken from the average college-educated white woman is $1.11.[57]

How OASI Benefit Calculations Contribute to the Wealth Gap

Since the Social Security Administration only uses the highest 35 years of indexed income to calculate benefits, early entry into the workforce also impacts rates of return. For a worker who earned $15,500 annually for the first five (uncounted) years of his or her 40 years in the workforce, the contributions of those five years translate into a pure tax of more than $8,000. Although this facet of the current system affects Americans of all backgrounds, it disparately impacts African Americans, who are 9 percent more likely to enter the workforce prior to the

[53] Centers for Disease Control and Prevention.
[54] President's Commission to Strengthen Social Security, Draft Interim Report, p. 6.
[55] Jeffrey Brown, p. 6.
[56] Brown, p. 26.
[57] Brown, p. 11.

completion of high school than whites and 11 percent more likely to enter the workforce before earning an undergraduate degree than whites.[58]

Social Security's Impact on Inheritances

It should not be surprising that Social Security's forced annuitization also contributes to differences in inheritances. While many analysts suggest that inheritances have a dramatic effect on the wealth distribution, a study for the National Bureau of Economic Research found that inheritances are an important contributor to wealth inequality "only in the presence of Social Security."[59]

This is because, by annuitizing a far greater percentage of the retirement savings of the poor, Social Security all but eliminates their inheritances and dramatically reduces those of the middle classes. Since lower-income Americans have less disposable income to invest, payroll taxes greatly reduce their opportunity to build wealth that could form an estate. According to the study, inherited wealth is mainly distributed according to chance, with Social Security nearly excluding low-income Americans from this distribution due to forced annuitization of their retirement savings.[60]

Another study published by the Federal Reserve Bank of Cleveland helps to quantify these findings: it estimates that Social Security "reduces the intergenerational flow of inheritances by 50 percent," with almost all of the reduction coming from middle-and low-income households.[61] Since "the payroll tax reduces the lifetime resources of those earning less than the taxable limit ($84,600) by a relatively greater proportion than those earning above this limit,"[62] forced annuitization leaves a large percentage of low-income households with very little wealth at death, while wealthier households accumulate roughly the same amount of wealth than they would have absent Social Security.[63]

The above discussion is not meant to suggest one can substitute "low-income" households with "African American" households, but only to help explain the wealth gap between white and black households. Because the median African American household income is $25,500, compared to $45,200 for white households,[64] a greater percentage of African American families are negatively affected by OASI's constraint on inheritances than their white counterparts.

A study by Edward N. Wolff underscores this. He found that between 1984-1994, inheritances and gifts received by African Americans were only 28 percent of those received by whites, including all educational and income groups.[65]

---

[58] Jennifer Cheeseman Day and Eric C. Newburger, "The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings." Current Population Reports, Economics and Statistics Administration, U.S. Census Bureau, P23-210, July 2002.
[59] Jagadeesh Gokhale et al., p. 1.
[60] Gokhale et al., p. 10.
[61] Federal Reserve Bank of Cleveland Working paper No. 49. Also available as NBER Working Paper 9811, p. 28.
[62] Federal Reserve Bank of Cleveland, p. 26.
[63] Federal Reserve Bank of Cleveland p. 27.
[64] Federal Reserve Bulletin, p. 5.
[65] Edward N. Wolff, p. 24.

The President's Commission and Criticisms of Reform

At its conclusion, the President's Commission to Strengthen Social Security encouraged Congress to begin a national discussion on how best to include personal retirement accounts in Social Security. As the commission recognized, reform could help reverse current trends in racial wealth inequality by encouraging lower-income families to acquire financial assets. Higher-income African American families would benefit as well because the evident benefits of such reform might spur them to not only invest a portion of their payroll taxes in personal accounts but also to invest a greater portion of their disposable income.

Implementation of personal Social Security accounts would also address the ways the current program disadvantages African Americans by tying benefits to life expectancy and limiting the inheritances of lower-income families. By creating a savings component and addressing the ways the current program uniquely disadvantages African Americans, reform would produce the kind of advancement in social insurance that Senator Moynihan and the commission envisioned.

The Final Report

In December of 2001, the commission issued its final report, entitled, "Strengthening Social Security and Creating Personal Wealth for All Americans." The report offered three reform models based on voluntary private accounts: the first model is an "add-on" to the current program that would allow workers to invest 2 percent of their taxable wages in a personal account in exchange for a reduction in "guaranteed" benefits; the second allows workers to direct 4 percent of their payroll taxes (up to $1,000 annually) to a private account, with benefit guarantees for low-income workers; the third provides a 2.5-percent government match for any worker who voluntarily sets one percent of his taxable income aside each year, and contains similar protections for low-income workers as the second proposal.[66]

Importantly, all three of the reform models offered by the President's Commission would transfer ownership of the personal account to the worker, allow workers to invest in regulated funds of their choosing, and allow workers to bequeath the account to heirs at the time of death. However implemented, if reform provides workers with the flexibility to invest in corporate stocks, bonds, and treasury securities, and confers clear ownership rights to those assets, it will correct the flaws of the current system that disadvantage African Americans relative to whites, and it will allow all Americans to build an estate.

All three of the reform proposals would also provide a financial building block to the next generation. If an individual were able to devote his or her OASI contributions in a stock mutual fund that returned 5.5 percent annually – a figure *well below* historical averages – the account would be worth $36,475 after 10 years. This figure is not only 92 percent higher than the median African American household net worth,[67] it is a large enough sum to entice future contributions to other tax-free savings accounts. Even under the most conservative of the commission's three proposals, low-income workers' benefits would not only be 32 percent higher in real terms over 30 years, that wealth could be passed on to the next generation.[68]

---

[66] The Report is Available in its entirety at: http://csss.gov/reports/Final_report.pdf.
[67] Federal Reserve, p. 8.
[68] The Final Report of the President's Commission to Strengthen Social Security, p. 19

Criticisms of Reform

Although few could argue with the assertion that the OASI component of Social Security disadvantages African Americans relative to whites, some, including the National Association for the Advancement of Colored People (NAACP) and the Urban League, contend that personal accounts would drain resources from the parts of the Social Security system that provide disproportionate benefits to African Americans.

Writing in *The New York Times* in opposition to personal accounts, NAACP Chairman Julian Bond and Urban League President Hugh Price voice concern about families' financial security in the event that a parent whose personal account had not accumulated sufficient assets dies unexpectedly. Bond and Price also insist that personal accounts would divert funds from Disability Insurance (DI), which would negatively affect African Americans. [69]

Although both DI and survivors' benefits are financed through payroll taxes and share the same "trust fund" as OASI, there is no reason to conclude peremptorily that personal retirement accounts would reduce the funds available for either program. Whereas OASI's longevity insurance structure has outgrown its usefulness, rare events, like unplanned disability or premature death, remain well suited for an insurance model.

OASI survivors' benefits are paid monthly to the children of a deceased parent and their surviving parent if the child is under 16 years of age. In addition, a surviving spouse already collecting Social Security benefits receives approximately two-thirds of the combined benefits the couple received prior to a spouse's death. African American children represent 22 percent of survivors' insurance beneficiaries, compared to approximately 12 percent of the population as a whole, and would be impacted disproportionately if survivors' benefits were reduced.[70]

However, the plausibility of a premature death should not diminish the argument for personal savings accounts, but simply illustrates the need for the continuation of a life insurance component to Social Security. Whether this insurance is privately administered – a term life-insurance policy is highly affordable for a person in his or her early employment years[71] – or financed through payroll taxes and distributed through the Social Security Administration as in the current system, personal accounts would not put dependents or young spouses in jeopardy.

Moreover, 85 percent of Americans collecting survivors' benefits are aged widows and widowers. With personal accounts, tomorrow's surviving spouses are likely to fare much better than under the current program: recall that under current law, OASI benefits to the surviving spouse become two-thirds of what they were prior to the spouse's death, whereas he or she would inherit a personal account in its entirety.[72]

Analysis of the DI program shows that African Americans do benefit disproportionately from DI, as they make up about 12 percent of the U.S. population and 17 percent of DI

---

[69] Hugh Price and Julian Bond, "Social Security's Stable Benefit," *New York Times*, July 26, 2001.
[70] Price and Bond.
[71] See quotes at: https://www.insurance.com/.
[72] Melissa Hieger and William Shipman, "Common Objections to a Market-Based Social Security System: A Response," Cato Institute, July 22, 1997.

beneficiaries.[73] But again, it is difficult to see how the introduction of personal accounts to improve OASI would affect this related, but distinct program. The President's commission made no recommendations concerning DI, stating: "Other factors affect the DI program that are more complex and may require a unique set of solutions... A reformed Social Security system must take into account the fact that a planned retirement is a very different life event from an unplanned onset of disability."[74]

As an insurance system, OASI is failing because it underwrites the risk of an event (living to age 65) that has become commonplace. By contrast, basing DI and survivors' benefits (for pre-retirement dependents) on the model of a private insurance market makes sense, as indemnity payments are triggered by a rare and truly unpredictable event in both cases. Personal retirement accounts should do nothing to weaken the funding, or underlying logic, for these two components of Social Security.

Achieving the American Dream

A free and functional market-based economy rewards hard work, business acumen, ingenuity, thrift, and deferral of gratification. Because such attributes are not distributed evenly, it should be no surprise that the economic rewards for them are not either. Undue focus on unequal outcomes often obscures the way economic growth benefits all of society. Policymakers should be wary of "solutions" to artificially redistribute wealth coercively because they could have negative consequences, including the erosion of personal freedom, the elimination of incentives that lead to economic growth, and reduced technological innovation.

However, it is clear that the current OASI program greatly contributes to the wealth gap between white and African American households, not only by what it does, but also by what it does not do. OASI modernization, based on personal retirement accounts, would constitute a serious effort to confront the wealth gap and encourage wealth accumulation by all Americans. As former Senator Bob Kerrey argued, "It is very important, especially for those of us who have already accumulated wealth, to write laws to enable other people to accumulate it."[75] This is critical to achieving the American dream.

Although critics of reform use meaningless code words to attack personal accounts, like "privatization," the fact is that such accounts represent a necessary and significant step forward for social insurance. As Senator Moynihan wrote: "Now we have the opportunity for a grand culmination, starting this century with a system of voluntary, contributory savings plans such that Americans will end their working lives with a measure of wealth. An estate. And for the first time, an American idea!"[76]

Analysis of Fed data makes it clear that the difference in asset ownership rates is the biggest contributor to the wealth gap. It is now up to policymakers to take the steps necessary to help non-investors join in the dynamism of the U.S. economy through OASI modernization that could allow all American households to build an estate and narrow the wealth gap in the process.

Written by RPC Economic Analyst Jason Thomas, 224-2946

---

[73] Price and Bond.
[74] Final Report, p. 150.
[75] Sen. Robert Kerrey, quoted in Final Report, p. 8.
[76] Moynihan, "Building Wealth for Everyone."