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SOCIAL SECURITY AND HISPANICS: A REPLY TO THE HERITAGE FOUNDATION

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In 1998, the Heritage Foundation issued reports portraying Social Security as a bad deal for Hispanic Americans and African Americans and touting private accounts as a vastly superior alternative.[1] The reports rested upon severe distortions and misuse of data. In a series of striking and unusual developments, Stephen Goss, now Chief Actuary of the Social Security Administration, and Robert Myers, the former chief Actuary who for decades was the leading Social Security adviser to Congressional Republican leaders and served as Executive Director of the 1983 Greenspan Commission, issued analyses excoriating the Heritage reports for violating basic analytic standards.

In an analysis issued by the Office of the Chief Actuary, Goss wrote: "The [Heritage] approach consistently overstates the expected number of years of work and consistently underestimates the expected number of years [of benefits] after reaching retirement age. As a result, it grossly understates the expected rates of return from Social Security retirement benefits."[2] Goss also noted that "by their [Heritage's] own calculations…Hispanic Americans would be expected to receive a substantially higher rate of return from Social Security than would the general population, on average" but that Heritage had failed to acknowledge this finding in its report.[3] Myers' critique of the Heritage reports, published in *The Actuary* magazine, was, if anything, even more damning. He described the Heritage Foundation results as "grossly in error due to faulty methodology."[4]

Despite these sharply critical assessments of the Heritage reports, Heritage declined to withdraw, or even to correct, the reports. It has continued to promote these reports in minority communities in the seven years since.

[1] William W. Beach and Gareth G. Davis, "Social Security's Rate of Return for Hispanic Americans," Heritage Foundation, March 27, 1998, available at http://www.heritage.org/Research/SocialSecurity/CDA98-02.cfm.

[2] Memorandum from Steve Goss, Deputy Chief Actuary, "Problems with 'Social Security's Rate of Return': A Report of the Heritage Center for Data Analysis," February 4, 1998.

[3] Memorandum from Stephen C. Goss, Deputy Chief Actuary, to Harry C. Ballantyne, Chief Actuary, "Comments on Heritage Rates of Return for Hispanic Americans," Social Security Administration, April 2, 1998.

[4] Robert J. Myers, "A Glaring Error: Why One Study of Social Security Misstates Returns," *The Actuary*, September 1998, p. 5, available at http://library.soa.org/library/actuary/1990-99/ACT9809.pdf. See also Kilolo Kijakazi, "African Americans, Hispanics Americans, and Social Security: the Shortcomings of the Heritage Foundation Reports," Center on Budget and Policy Priorities, October 1998.

On June 28, 2005 the Center on Budget and Policy Priorities issued two analyses and a related policy brief on issues related to Hispanics and Social Security.[5] These analyses, co-authored with Fernando Torres-Gil, Director of the UCLA Center on Policy Research on Aging, sought to assess carefully the research and data in the field and to discuss the policy implications. On June 30, the Heritage Foundation issued an attack on the Center analyses.[6] The Heritage attack exhibits some of the same trademarks of the earlier Heritage reports. It rests heavily on distortion and misrepresentation.

Setting up "Straw Men" by Misrepresenting the Center's Analyses

The Heritage attack claims that the CBPP's reports reject measures to bring Social Security deficits and revenues into line and thus that "CBPP endorses the continuation of the status quo." This is simply incorrect. The Center's reports repeatedly state that a balanced mix of benefit reductions and progressive revenue increases to restore long-term Social Security solvency is needed. Several specific measures are discussed.

Heritage ignores this. It implies instead that the Center favors either letting the trust fund become insolvent, leading to large benefit cuts after that date, or substantially raising the payroll tax rate to cover scheduled benefits. Heritage launches into a discussion of why either outcome would be adverse for Hispanics.

But the Center reports do call for action to restore solvency, contrary to the Heritage claims, and the Center's proposals *do not* involve raising the payroll tax rate. The CBPP reports criticize the President's Social Security plan for relying solely on benefit cuts to restore solvency, an approach that would be injurious to the Hispanic community. The reports explain that Hispanics would fare better under plans that restore solvency through a mix of benefit adjustments and progressive revenue enhancements.

The CBPP reports go on to present a series of options to bolster Social Security's revenues, none of which involve raising the payroll tax rate. These options include raising the Social Security payroll tax cap (now set at $90,000), an idea floated earlier this year by Senator Lindsay Graham (R-SC); imposing a small tax on earnings above the payroll tax cap, as proposed by economists Peter Diamond and Peter Orszag; and maintaining a scaled-back estate tax, perhaps at its 2009 parameters (i.e., with a $7 million exemption for couples and a $3.5 million exemption for individuals) and dedicating the revenue from that estate tax to Social Security. These revenue-raising approaches would barely touch Hispanics; only two percent of Hispanic workers have earnings above the payroll tax cap in any year,[7] and, by 2011, only three-tenths of one percent of all estates would be

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[5] Fernando Torres-Gil, Robert Greenstein, and David Kamin**,** "The Importance of Social Security to the Hispanic Community," Center on Budget and Policy Priorities, June 28, 2005, available at http://www.cbpp.org/6-28-05socsec2.htm. Fernando Torres-Gil, Robert Greenstein, and David Kamin, "Hispanics and Social Security Reform: The Implications of Reform Proposals," Center on Budget and Policy Priorities, June 28, 2005, available at http://www.cbpp.org/6-28-05socsec3.htm. Fernando Torres-Gil, Robert Greenstein, and David Kamin, Policy Brief: "Hispanics' Large Stake in the Social Security Debate," June 28, 2005, available at http://www.cbpp.org/6-28-05socsec.htm.

[6] William W. Beach and Andrew M. Grossman, "Hispanic Workers Should Back Personal Accounts," Heritage Foundation, June 30, 2005, available at http://www.heritage.org/Research/SocialSecurity/wm782.cfm.

7 Census Bureau, Current Population Survey, March 2004, data available at http://ferret.bls.census.gov/macro/032004/perinc/new10_001.htm.

affected by an estate tax with these features, according to data from the Urban-Brookings Tax Policy Center. Heritage fails to acknowledge either that these are the revenue proposals the Center reports recommend or that the reports call for combining one or more such measures with adjustments in Social Security benefits to produce a balanced package that restores solvency.

The "Nest Egg"

Heritage also misrepresents other Center policy recommendations as well as the policy course that Heritage itself favors with regard to private accounts. Heritage touts the approach that it favors — "carve-out" private accounts — as allowing "low- and moderate-income workers voluntarily to build a nest egg for themselves and their children by setting aside some of their own Social Security taxes in a Personal Retirement Account." Heritage fails to disclose that under the proposals for "carve-out" private accounts (such as the President's proposal and the plan recently offered by Senator Jim DeMint), a worker's Social Security benefits would be reduced in return for the worker's being allowed to divert some of his or her payroll tax revenue into an account. Specifically, a worker's Social Security benefits would be cut dollar for dollar for each dollar he or she deposited in a private account and would be cut in addition by the amount that the account would have accumulated if the account had earned 2.7 percent to 3.0 percent above the inflation rate (or about 5.5 percent overall). Workers whose accounts earned less than this would lose money on the deal; they would be made worse off by electing a private account. Workers whose accounts earned more than this would come out ahead. In a recent analysis of the private accounts that President Bush has proposed, Yale economist and noted financial market expert Robert Shiller (author of *Irrational Exuberance*) projected that people electing the accounts would end up worse off 32 percent to 71 percent of the time.[8]

As a result, what Heritage proposes is less a "nest egg" than a bet. Some people would come out ahead. Others would lose.

A sounder and more secure approach to building a "nest egg" is discussed in the Center reports. Although Heritage says the Center reports argue that young workers, including Hispanics, "should rely *more* on Social Security as it is currently constructed" (emphasis added), the opposite is true. The Center analyses explain that Hispanics rely more on Social Security in retirement than do other workers in large part because Hispanics have much lower rates of participation in employer-sponsored pension plans and much less in retirement saving. The Center analyses call for substantial reforms in tax incentives and other rules related to pension and retirement plans in order to bolster retirement saving by Hispanics.

Recent studies demonstrate persuasively that modifying employer-sponsored plans by converting them to "automatic enrollment" plans, in which workers are enrolled automatically unless they opt out, could increase participation substantially among Hispanics.[9] Another key reform would involve expanding a feature of the tax code known as the saver's credit and extending this credit to workers who do not earn enough to owe federal income tax. This, too, would have a large effect on Hispanics. These and other such reforms related to retirement saving have been discussed in a series of important papers issued in recent months by the Retirement Security Project at the Brookings Institution. Such reforms would enable many more Hispanics to build retirement

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[8] Robert J. Shiller, "The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation," March 2005, available at http://www.irrationalexuberance.com/shillersocsec.doc.

[9] See, for example, Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics*, vol. 116, no. 4, November 2001.

accounts — a nest egg, if you will — *on top of* Social Security, rather than doing as the Heritage Foundation favors and merely replacing one type of "nest egg," guaranteed Social Security benefits, with another type of "nest egg" in the form of personal accounts.

To be sure, if more low- and moderate-income workers — including more Hispanics — start building tax-favored retirement accounts such as 401(k)s and IRAs, there will be a cost to the Treasury. These costs should be offset, not deficit financed. That can be done by closing unproductive tax breaks — a report issued earlier this year by the Congressional Joint Tax Committee identified tens of billions of dollars of potential savings in this area — and by scaling back excessive tax cuts enacted in recent years for those at the top of the income scale. The Urban Institute-Brookings Institution Tax Policy Center reports that when the tax cuts enacted in recent years are fully in effect, people who make more than $1 million a year will receive annual tax cuts averaging more than $135,000 each, in today's dollars. Scaling back such tax cuts and closing unproductive special-interest tax breaks would be a more beneficial way to fund retirement saving accounts for Hispanic Americans than to fund such accounts by cutting Social Security benefits.

Misrepresenting the Views of the Congressional Budget Office

Finally, the Heritage paper misrepresents the views of the Congressional Budget Office. In its reports, CBO has explained that: 1) on average, stocks generate a higher rate of return than bonds; 2) the reason that the average return is higher on stocks than on bonds is that stocks are riskier investments and must offer a higher average return over time to induce people to take the risk of investing in them; and 3) in assessing the returns that workers would receive from private accounts invested partly in stocks, analysts must adjust the average returns from stocks downward to reflect the fact that those returns are only averages and that many people will do less well.[10] This process is known as "risk adjustment." It is scrupulously followed in all CBO reports in which CBO estimates the retirement income that workers would receive under plans that would replace part of Social Security with private accounts. (The Office of Management and Budget also uses this approach in its budgetary treatment of the finances of the Railroad Retirement System.[11])

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[10] For instance, CBO endorsed the concept of risk adjustment in a report issued several years ago in which it examined the effect of having the U.S. Government shift some of its assets from Treasury bonds to stocks. CBO wrote: "Government investment in private securities does not offer a free lunch: although it would increase the expected value of budgetary resources, it would do so at the cost of exposing the government, future taxpayers, and beneficiaries of federal programs to greater risk. If that risk was taken into account, the returns on private securities would be no greater than the returns on government securities." CBO, Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities, 2003, available at http://www.cbo.gov/showdoc.cfm?index=4023&sequence=0.

Accordingly, CBO uses risk adjustment when it estimates the returns that private accounts included in Social Security plans would produce. CBO has explained, "…the effects of the higher expected returns in [individual accounts] investments are computed net of the cost of the additional risk. Thus, the returns are 'risk-adjusted' and set equal to the returns on Treasury bonds." CBO, Long-term Analysis of Plan 2 of the President's Commission to Strengthen Social Security, 2004, available at http://www.cbo.gov/showdoc.cfm?index=5666&sequence=0.

The Center analyses follow the CBO methodology to the letter. Nevertheless, Heritage portrays the use of this methodology by the Center as something that CBO has said is “wrong.” Heritage’s approach is deceptive here. CBO Director Douglas Holtz-Eakin responded to a reporter a few months ago that it would be wrong to say that stocks do not produce a higher average return than bonds (i.e., point #1 in the previous paragraph). Heritage cites this statement to make it appear as though Holtz-Eakin thinks that “risk adjustment” itself — the very approach that CBO itself employs in its reports and that the Center reports replicate — is wrong and should not be used. Heritage does not explain that this methodology is the basic methodology that CBO itself employs.

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[11] The Office of Management and Budget uses “risk adjustment” in its budgetary accounting of the stock-market investments made by the Railroad Retirement system. As OMB explains, “Equities and private bonds earn a higher return on average than the Treasury rate, but that return is subject to greater uncertainty. Sound budgeting principles require that estimates of future trust fund balances reflect both the average return and the cost of risk associated with the uncertainty of that return… Economic theory suggests, however, that the difference between the expected return of a risky liquid asset and the Treasury rate is equal to the cost of the asset’s additional risk as priced by the market. Following through on this insight, the best way to project the rate of return on the Fund’s balances is to use a Treasury rate.” See Office and Management and Budget, *Analytical Perspectives, Fiscal Year 2006 Budget*, February 2005, p. 421.