

BRIEF ANALYSIS

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African Americans Benefit Most from Personal Retirement Accounts

by NCPA Staff

All Americans would benefit from Social Security reform, but African Americans would benefit the most. African Americans rely more heavily than other demographic groups on Social Security for a secure retirement; thus they stand to lose the most from an unreformed system.

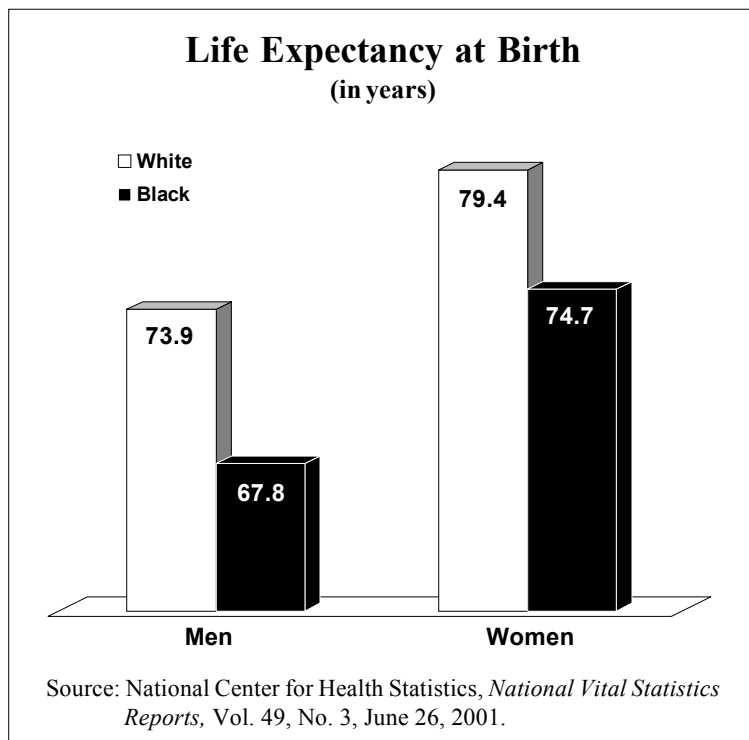
African Americans Depend More on Social Security. The Social Security system was designed to supplement personal retirement savings, but it has become a lifeline for many African Americans. At every income level, blacks are more dependent on Social Security benefits than whites. According to the Cato Institute, three of four African American retirees rely on Social Security for half or more of their retirement income, and 37 percent of African American seniors rely on Social Security for all of their income. Without Social Security benefits, the poverty rate for African American retirees would increase from 21 percent to 60 percent.

Social Security's Lower Rate of Return. The implicit rate of return on Social Security payroll taxes is well below what could be earned on private investments. According to a recent study by Laurence J. Kotlikoff comparing likely benefits to payroll taxes paid, baby boomers can expect a real rate of return of less than 2 percent and Generation Xers less than 1 percent. Today's newborns will earn a rate of return close to zero.

By comparison, in any 35-year period over the last 128 years, the inflation-adjusted annual return on stocks in the Standard & Poor's composite index has

averaged 6.4 percent per year. During that period, a portfolio of 60 percent stocks and 40 percent bonds produced an average annual real return of 5.1 percent. Although Social Security's rate of return is dismal for all Americans, it is particularly bad for African Americans:

- According to an NCPA study by Liquin Liu and Andrew J. Rettenmaier, a 20-year-old black male can expect a real rate of return of only 0.73 percent, while a white male can expect a return of 1.82 percent.



- White 20-year-old males can expect 47 cents in benefits for every \$1 they pay in taxes; 20-year old black males can expect to receive only 34 cents.

Why Is the Rate of Return for African Americans So Poor? Social Security payroll taxes are paid throughout one's working life, but the system pays full retirement benefits only after retirement, normally at age 65. For young workers, the normal retirement age is being increased to 67. Thus the rate of return is inherently linked to length of life. African Americans, however, have a shorter average life expectancy than whites across all income levels.

- The average life expectancy at birth for a black male is 67.8 years, while a white male can expect to live to age 73.9. [See the Figure.]
- Average life expectancy for a black woman is 74.7, compared to 79.4 for whites.
- Based on these numbers, a black male can expect to pay Social Security taxes for his entire working life but receive less than a year of benefits. White females will collect benefits for almost 5 years longer than black women.
- Because of differences in life expectancy, African Americans average nearly \$21,000 less than whites in lifetime Social Security benefits, according to President Bush's Commission to Strengthen Social Security.

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In general, African Americans are over-represented among taxpayers and under-represented among beneficiaries. So one way to see Social Security is as a system in which African American workers subsidize the retirements of longer-living whites.

African Americans' rate of return is also adversely affected by the calculation of Social Security benefits. Social Security benefits are based on the highest 35 years of wage income. African Americans are more likely than whites to forgo college and enter the work force at a younger age. Although a 19-year-old worker can look forward to 46 years of work before becoming eligible for Social Security, more than a decade of that work will be ignored in Social Security benefit calculations. Thus the extra taxes paid by African Americans who enter the workforce early results in no extra benefits.

Social Security Is in Trouble. The situation is already bad, and soon it will get worse. In less than a decade, baby boomers will begin to retire. In a relatively short period of time, 77 million people will stop paying taxes and start receiving Social Security benefits. By 2017, Social Security will begin running a deficit as benefits paid outstrip payroll tax receipts. For the long run, Social Security faces an unfunded debt of more than \$25 trillion. Unless the system is reformed, either benefits will have to be cut by one-third or taxes will have to be increased by one-half to keep the system in balance. Either option would disproportionately affect African Americans.

Increasing the payroll tax would further gouge workers' incomes. The payroll tax would have to increase from 12.4 percent to 17 percent in 2030 and continue to grow to more than 19 percent by 2075 in order to pay all promised benefits. A tax increase of this size would thrust millions more blacks into poverty. Furthermore, the payroll tax only taxes wages, which represent a higher proportion of African Americans' income. Thus a payroll tax increase would take a higher percentage of blacks' incomes than of whites'.

Cutting benefits would also plunge into poverty millions of retirees who depend on Social Security for all or most of their retirement income, including 75 percent of African Americans. If benefits are cut by raising the retirement age, more and more African Americans will never live to see a single check.

PRAs Will Help African Americans. Under a number of reform proposals being considered, work-

ers would be able to invest 2 percentage points of the payroll tax in a personal retirement account (PRA) and reap the rewards of compounded interest.

Allowing individuals to place a portion of their payroll taxes into PRAs — accounts similar to an IRA (Individual Retirement Account) or 401(k) retirement plan, but with strict regulations requiring diverse, conservative investments — would benefit African Americans in three ways.

- PRAs would disconnect benefits from life expectancy because the rate of return would depend on the investment of wages, not on age.
- PRAs would allow African Americans to capitalize on additional working years by investing for retirement while still young.
- Since PRAs would be individually owned, African Americans could accumulate wealth in guaranteed investments and pass it down to heirs.

PRAs would give low-wage workers in general and African Americans in particular a chance to close the “wealth gap” and to enrich the lives of future generations. Not only would they make the benefit system fairer for African Americans, but PRAs would also provide a higher rate of return, lifting more blacks out of retirement poverty.

African Americans Support Personal Retirement Accounts. African Americans understand that they have the most to lose under the current Social Security system. Blacks are more likely to support PRAs than whites, and they support more aggressive changes to the system. Fifty-eight percent of African Americans favor changing Social Security into a system of personal accounts, while only 32 percent oppose it. More than half of all blacks want to be able to invest at least half of the 12.4 percent total payroll tax, and over a quarter want to invest the entire 12.4 percent.

Conclusion. African Americans clearly realize they are the losers in the current Social Security system. They are disproportionately reliant on the current system's low rate of return, lack of inheritance rights and financial instability. Personal retirement accounts would allow African Americans the opportunity to earn higher rates of return, save for their own retirement, and accumulate wealth to bequeath to their heirs.

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