The Heritage Foundation
Backgrounder
Executive Summary

No. 1227 October 19, 1998

HOW PUBLIC POLICY REFORMS WOULD UNLEASH HISPANIC AMERICA'S ECONOMIC POTENTIAL

WILLIAM W. BEACH, GARETH G. DAVIS, REA S. HEDERMAN, KIRK JOHNSON, AND NINA SHOKRAII REES

Congress and the President have arrived at an important juncture in public policy. Over the next six years, and before the "baby boom" generation begins to drain away the resources of Medicare and Social Security, Washington policymakers can make a number of changes in education, tax, and retirement policies that promise significant improvements in the well-being of all Americans.

To illustrate how specific policy changes can promote economic prosperity, Heritage Foundation analysts conducted a series of economic and statistical analyses to determine how potential changes would affect various socioeconomic groups. Although such reforms as making vouchers available to parents for their children's education, enacting a flat tax, and privatizing portions of Social Security would benefit all Americans, understanding how they would benefit a vibrant and growing population like Hispanic-Americans offers Congress a clear example of the promise they hold for workers and families in general.

Education Reform. According to the Census Bureau's Current Population Survey, Hispanic-American students have the lowest level of educational attainment of any major segment of the U.S. population. Only about 53 percent of Hispanic students over the age of 25 in 1993 had completed high school, and only about 9 percent held a bachelor's degree. Especially troubling is that 46.9 percent of Hispanic students did not graduate from high school at all. Lack of a high school degree significantly influences a student's overall lifetime earnings potential.

Produced by the
Domestic Policy Studies
Department

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002-4999
(202) 546-4400
http://www.heritage.org

LEADERSHIP FOR AMERICA · THE HERITAGE FOUNDATION · HERITAGE · 25 YEARS

Educational reforms that put parents, teachers, and principals in charge of educating children would benefit these underachieving Hispanic-American students. Congress should devolve decision-making authority and education dollars from the federal bureaucracy back to the states, sending at least 95 percent of the funding directly into the classroom and into programs like vouchers that empower parents to find the best school setting for their children.

Tax Reform. The current income and payroll tax systems offer low- and moderate-income families little opportunity to achieve significant economic improvement. By taxing income when it is saved and again when it is invested, the tax code discourages many people from saving or investing for the future. This serves only to slow the economy, reduce job growth, and retard wage increases.

The payroll and income taxes paid by an average-income family consume a higher percentage of that family's income than do taxes paid by higher-income families. This regressivity harms Hispanic-American workers particularly. Their median annual income of $24,900 is barely high enough to create income tax liability, yet 15 percent of every wage dollar they earn is taxed to support Social Security and Medicare.

A simple and fair tax system, such as a flat tax, would go far toward correcting some of the regressive aspects of current federal tax policy. For this reason, many of the proposed flat tax plans before Congress call for family allowances that would give a family of four a deduction of between $30,000 and $36,000. Family allowances at these levels would move at least two million low-income Hispanic-Americans off the tax rolls.

Social Security Reform. One of the major challenges facing Hispanic communities is the relative absence of local capital. Capital shortfall means that Hispanic-Americans face greater difficulties in starting a business, purchasing a quality education for their children, and accessing adequate health care in their own communities. Privatizing a significant portion of the current Old-Age and Survivors Insurance program not only would save Social Security from bankruptcy, but also would permit low- and moderate-income Americans of all ethnic backgrounds, including Hispanic-Americans, to build capital in their own communities.

Conclusion. Unleashing the economic potential of all Americans, and especially Hispanic-Americans, will require many things: changing current education policy, lifting the heavy and growing tax burden from the shoulders of hardworking Americans, and permitting workers to invest a portion of their payroll taxes in bond and stock portfolios to build income for retirement and their children's future. Such changes in key federal policies can enable *all* Americans to use their individual talents to achieve greater economic rewards and individual well-being in the coming decades.

—*William W. Beach is John M. Olin Senior Fellow in Economics and Director of The Center for Data Analysis at The Heritage Foundation. Gareth G. Davis and Kirk Johnson are Policy Analysts, and Rea S. Hederman is a Research Analyst, in The Center for Data Analysis. Nina Shokraii Rees is Education Policy Analyst at The Heritage Foundation.*

The Heritage Foundation
Backgrounder
214 Massachusetts Avenue, N.E. Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

No. 1227 October 19, 1998

HOW PUBLIC POLICY REFORMS WOULD UNLEASH HISPANIC AMERICA'S ECONOMIC POTENTIAL

WILLIAM W. BEACH, GARETH G. DAVIS, REA S. HEDERMAN, KIRK JOHNSON, AND NINA SHOKRAII REES

Over the next six years, the actions of Washington policymakers in reforming education, the income tax system, and Social Security will affect every American, but particularly those who struggle most to achieve prosperity. Congress and the President have arrived reluctantly at the moment of decision: Now, after years of talking about these issues, the problems of current programs are so great that immediate action is required. Either policymakers will enact changes that positively influence the economic direction of the country and the ability of families to care for themselves and transfer wealth to the next generation to build significantly better lives, or they will squander an opportunity to enact serious reforms by choosing inaction or making only ineffective change.

To illustrate how specific policy changes can promote economic prosperity, Heritage Foundation analysts have conducted a series of economic and statistical analyses over the past few months to determine how these changes would affect various socioeconomic groups. Although such reforms as making vouchers or scholarships available to parents for their children's education, enacting a flat tax, and privatizing portions of Social Security would benefit all Americans, understanding how they would benefit a vibrant and growing population like Hispanic-Americans offers Congress a clear example of the promise they hold for workers and families in general.

Education Reform. Great room exists for improving and expanding educational opportunity for American children, but particularly for Hispanic students. In 1993, only about 53 percent of Hispanic-American 25-year-olds had graduated from high school, and fewer than 10 percent had earned a bachelor's degree. Coupling tight economic times with the normal challenges that face immigrants to the United States is not a recipe for educational success, and the education dollars they need to prevent their children from dropping out of school to earn an income are scarce.

Produced by the
Domestic Policy Studies
Department

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002-4999
(202) 546-4400
http://www.heritage.org

LEADERSHIP FOR AMERICA · HERITAGE · 25 YEARS · THE HERITAGE FOUNDATION

Reforms that put parents, teachers, and principals in charge of the education of children would benefit underachieving Hispanic-American students especially. Congress should devolve decision-making authority and education dollars from the federal bureaucracy back to the states, sending at least 95 percent of the funding directly into the classroom[1] and programs like vouchers that empower parents to find the best school setting for their children.

Tax Reform. The current income and payroll tax systems offer low- and moderate-income families little opportunity to achieve significant economic improvement. The tax code's bias against savings and investment (by taxing income when it is saved and again when it is invested) prevents many people from saving or investing for the future. This in turn slows the economy, reduces job growth, and retards wage increases. In addition, current tax law is so complex that small and emerging businesses pay as much to accountants and lawyers to keep them in compliance with the code as they pay in taxes.

The tax code is regressive: Adding the payroll tax to the income taxes paid by an average-income family consumes a higher percentage of that family's income than do taxes paid by higher-income families.[2] This regressivity harms Hispanic-American workers particularly. Their median annual income of $24,900 is barely high enough to create an income tax liability, yet 15 percent of every wage dollar they earn is taxed to support Social Security and Medicare. A 15 percent payroll tax means that most Hispanic-American workers pay more in social insurance taxes than in income taxes, and payroll taxes have no deductions or credits that would balance out the otherwise regressive nature of a single-rate tax.

A simple and fair tax system, such as a flat tax, would go far toward correcting some of the regressive aspects of current federal tax policy. Many of the proposed flat tax plans before Congress call for family allowances that would give a family of four a deduction of between $30,000 and $36,000.[3] Family allowances at these levels would facilitate moving 2.3 million low-income Hispanic-Americans off the tax rolls.

Social Security Reform. High taxes that reduce the growth of family income also, in part, support a retirement program that reduces family wealth. Social Security is the main (and often only) retirement program for low- and moderate-income workers. The high payroll taxes these workers incur for future retirement benefits might be justified if those taxes yielded rates of return that were at least equal to the most modest returns they could achieve from supplemental retirement savings. However, returns from Social Security for young and middle-aged workers are slipping below 2 percent. Each passing year sees further erosion in their Social Security "investment," which also widens the wealth gap in this country. Moreover, unlike regular savings and investment, the publicly funded retirement system provides nothing for the heirs of Social Security retirees except a $255 death benefit.

On top of this, Hispanic communities face a relative absence of local capital that they can use to start businesses, purchase quality education for their children, access adequate health care in their communities, and save for retirement. Although Hispanics and other minorities in America today have overcome many civil rights obstacles, this economic "sticky floor" remains. Creating local capital by privatizing a significant portion of the current Old-Age and Survivors Insurance program not only would permit low- and moderate-income Americans of all ethnic backgrounds to build capital in their own communities, but also would save Social Security from bankruptcy.[4] And it would go

1. The case for educational reform is set forth in Nina H. Shokraii and John S. Barry, "Education: Empowering Parents, Teachers, and Principals," in Stuart M. Butler and Kim R. Holmes, eds., *Issues '98: The Candidate's Briefing Book* (Washington, D.C.: The Heritage Foundation, 1998).
2. For a summary of the case for fundamental tax reform, see Daniel J. Mitchell, "A New Tax System: Simple, Fair, and Flat," in Butler and Holmes, eds., *Issues '98*.
3. H.R. 1040, sponsored by Representative Richard Armey (R–TX) and S. 1040, sponsored by Senator Richard Shelby (R–AL), propose a family allowance equal to $11,600 for each adult and $5,300 for each child. For additional information on the Armey–Shelby flat tax, see Mitchell, "A New Tax System," pp. 35–44.

far in lifting Hispanic-Americans and other minorities off that sticky floor.

HOW HISPANIC FAMILIES WOULD BENEFIT FROM EDUCATION REFORM

Unquestionably, opportunities for economic prosperity increase with one's level of educational attainment. As Table 1 demonstrates, in 1993 fewer Hispanic-American students received a high school diploma or a degree from a post-secondary school than did either white or black students, or students in the general population. Data from the Census Bureau's Current Population Survey demonstrate that Hispanic students, in fact, have the lowest levels of educational attainment of any major segment of the American population. Specifically, only 53.1 percent of Hispanic-American students over the age of 25 in 1993 had completed high school, and only about 9 percent hold a bachelor's degree.[5]

Especially troubling is that 46.9 percent of Hispanic students do not even graduate from high school. Lack of a high school degree significantly influences an individual's overall lifetime earnings potential. Average annual earnings in 1996 were nearly 40 percent higher for Hispanic students who had received a high school diploma than for those who had dropped out of high school ($18,528 versus $13,287, respectively, in nominal dollars).[6]

Even worse, according to the National Center for Education Statistics, 47 percent of Hispanic high school graduates—the vast majority of whom graduated from public schools—were either "marginally qualified" or "unqualified" for admittance to a four-year collegiate institution between 1992 and 1994.[7] And nearly 21 percent of Hispanic high school graduates were only "minimally qualified" for college. In short, two-thirds of all Hispanic high school graduates are minimally, marginally, or not qualified to begin college, compared with just over half of total high school graduates in the overall population.

Although the Hispanic population endures other barriers to education, such as high poverty levels and limited proficiency in English, the pub-

Table 1 B 1227

Educational Attainment of Persons Aged 25 and Over by Ethnic Group, 1993

	Not a High School Graduate	High School Graduate	Some College No Degree	Bachelor's Degree or More	Total No. of Graduates, High School or Higher
All Races	19.8%	35.4%	23.0%	21.9%	80.2%
White	18.5	35.6	23.3	22.6	81.5
Black	29.6	36.3	22.0	12.2	70.4
Hispanic	46.9	26.8	17.3	9.0	53.1
Other	21.0	26.6	18.5	33.9	79.0

Source: *U.S. Bureau of the Census, Current Population Survey for March 1993.*

4. A summary of the case for Social Security reform is presented in William W. Beach, Stuart M. Butler, Gareth G. Davis, and Daniel J. Mitchell, "Social Security: Improving Retirement Income for All Americans," in Butler and Holmes, eds., *Issues '98*.
5. See U.S. Bureau of the Census, *Current Population Survey for March 1993*. See Table 1, above.
6. *Mean Earnings of Workers 18 Years Old and Over, by Educational Attainment, Race, Hispanic Origin, and Gender: 1975 to 1996*, released by the U.S. Bureau of Census at *www.census.gov*, June 29, 1998.
7. Based on an index of factors such as high school grade point average and test scores. For more information, see the technical documentation in the National Education Longitudinal Study of 1988, Third Follow-up, 1994.

lic education establishment continually short-changes them in learning basic skills. As a result, according to the 1996 results of the National Assessment of Educational Progress (NAEP) exam, Hispanic students scored, on average, 8.4 percent lower than average students in math and 12.3 percent lower than their white non-Hispanic counterparts.

Yet Hispanic students perform markedly better, on average, in private and Catholic schools than they do in public schools. Table 2 shows average scores on the NAEP reading and math exams for 8th grade Hispanic students (age 13) by the type of school attended. Not only do Hispanic students perform better in private and parochial schools, but they also stay in school longer once they are there. In Catholic schools, for example, the Hispanic dropout rate falls to about 9.3 percent.[8]

Table 2 B 1227

Average 8th Grade Hispanic Test Scores by School Type

	Public Schools	All Private Schools	Private Catholic Schools	Percent Difference, Public-Private	Hispanic National Average	All Races National Average
Reading Test	233.5	283.0	261.3	21.2%	236.2	256.7
Math Test	240.1	272.4	261.4	13.5	242.0	263.7

Note: Test score range from 0–500.
Source: National Assessment of Education Progress, 1990 and 1992.

Derek Neal, an associate professor in economics at the University of Chicago, recently found that African-American and Hispanic students attending urban Catholic schools were more than twice as likely to graduate from college as their public school counterparts. He found that 27 percent of black and Hispanic Catholic school graduates who started college went on to graduate, compared with 11 percent of urban public school graduates. According to Neal's study, the probability that inner-city students would graduate from high school increases from 62 percent to at least 88 percent when those students are placed in a Catholic secondary school. Furthermore, compared with their public school counterparts, minority students in urban Catholic schools can expect to earn roughly 8 percent higher wages in the future.

The successes of a renowned math teacher at Garfield High School in Los Angeles demonstrate that low-income Hispanic students can excel if challenged to meet high standards. By demanding that all his students enroll in college-level Advanced Placement (AP) programs, in just a few years Jaime Escalante had more calculus exam takers than all but four other U.S. high schools in 1987. One of his protégé's, teacher Angelo Villavicencio at Ayala High in Chino Hills, California, was able to pass 80 percent of his calculus low-income minority students in 1995 using Escalante's methods.

The public school establishment should have been quick to replicate Escalante's success; yet AP classes are still confined to the select few, the best and the brightest in most American schools. This is symptomatic of the fact that, over the last half century, the public school establishment has effectively eliminated competition and thereby diminished the quality of public education in this country. However, it remains the only generally "affordable" alternative for the American population.

What Can Be Done?

The private sector is leading the way in demonstrating how innovative educational programs can help minorities and low-income students excel. For example, the National Council of La Raza, the premiere Hispanic-American advocacy group, developed a series of supplemental after-school academic programs called Projects EXCEL and EXCEL–MAS. The success of these programs illustrates that community-based education programs

8. James S. Coleman and Thomas Hoffer, *Public and Private Schools: The Impact of Communities* (New York: Basic Books, 1987).

help students learn potentially better than programs developed in the public school bureaucracy.

There are two basic types of market-based approaches to improving education in low-income communities: charter schools and school choice programs.

- **Charter Schools.** Public charter schools are run and managed independent of state and federal rules and regulations. Principals are given a greater amount of fiscal and legal autonomy to run these schools in return for demonstrable academic outcomes. The first charter school law was passed in 1990 in Minnesota. Today, 33 states and the District of Columbia have passed charter school legislation, resulting in 1,100 charter schools that serve over 235,000 students around the country.

  Recent studies of charter schools by the Hudson Institute and the U.S. Department of Education reveal their popularity with Hispanics and other at-risk students.[9] In fact, 25 percent of charter school students are Hispanic, and 40 percent of the existing charter schools serve dropout or at-risk youth. Charter schools attract the type of student that public schools fail to serve. Although it is too early to evaluate their academic outcomes, anecdotal evidence suggests that charter school students may even outperform their public school counterparts.

- **School Choice Programs.** School choice programs provide parents with funding to send their children to the private, public, or religious school of their choice. Such programs currently exist in the form of vouchers for low-income students in Milwaukee, Wisconsin, and Cleveland, Ohio, and education tax deductions and/or credits in Minnesota and Maine. Private organizations, such as the Children's Educational Opportunity Foundation (CEO America) and the Children's Scholarship Fund (CSF), provide partial assistance to low-income children to attend the school of their parents' choosing. Today, close to 88 privately funded programs serve a growing number of poor minority children, with many more still on waiting lists. For instance, the CEO America program in San Antonio, Texas—where about 80 percent of school-age children are Hispanic—already has placed 1,600 students (or 10 percent of the eligible student population) in schools of their choice.

To spur improvement in the public schools, and to provide better opportunities for children, two things are needed: (1) Individual public schools must be given greater autonomy from central office bureaucracy and the freedom to innovate, and (2) financial control must be put directly in the hands of parents, through vouchers and credits, so that public schools come under the financial market pressure to improve and parents possess the means to choose other schools when they do not. Improving the educational attainment of all students, but especially a group like Hispanic-Americans, will lay the groundwork for their economic prosperity in the future.

HOW HISPANIC-AMERICAN TAXPAYERS WOULD BENEFIT FROM FUNDAMENTAL TAX REFORM

According to a survey of Hispanic-American entrepreneurial activity published in *The Economist* in March, the fastest growing segment of small business in America is Hispanic-owned, and prospects for the continued growth of Hispanic businesses appear good.[10] However, the economic status of average Hispanic-Americans relative to the general U.S. population falls short on virtually every count. Specifically, in 1996,

9. Chester E. Finn, Jr., Bruno V. Manno, Louann A. Bierlein, and Gregg Vanourek, *Charter Schools in Action: Final Reports, Parts I–IV* (Washington, D.C.: Hudson Institute, June 1997), and *A Study of Charter Schools, First-Year Report*, U.S. Department of Education, Office of Educational Research and Improvement, 1997.

10. "America's Latinos: The Keenest Recruits to the Dream," *The Economist*, March 25, 1998, pp. 25–27.

Table 3 B 1227

Flat Tax at 17% Compared to Current Law For Hispanics Filing Tax Returns

Flat Tax Income in Thousands of Dollars	Number of Tax Returns in Thousands	Tax Liability Under Current Law: Mean Liability	Tax Liability Under Current Law: Sum (Millions)	Tax Liability under Flat Tax: Mean Liability	Tax Liability under Flat Tax: Sum (Millions)	Change in Tax Liability: Sum (Millions)	Change in Tax Liability: Percentage Change
Zero or less	55	$3,091	$1,695	$0	$0	-$1,695	-100.0%
0 to under 10	2,338	69	1,611	0	0	-1,611	-100.0%
10 to under 15	1,415	370	5,229	185	2,622	-2,607	-49.9%
15 to under 20	1,262	713	9,006	544	6,866	-2,139	-23.8%
20 to under 25	1,016	1,102	11,200	989	10,046	-1,154	-10.3%
25 to under 30	832	1,704	14,171	1,490	12,390	-1,781	-12.6%
30 to under 40	1,129	2,482	28,015	2,218	25,029	-2,985	-10.7%
40 to under 50	729	3,833	27,960	3,525	25,714	-2,247	-8.0%
50 to under 75	904	6,622	59,885	6,221	56,255	-3,630	-6.1%
75 to under 100	274	13,111	35,959	10,335	28,345	-7,614	-21.2%
100 to under 200	156	21,495	33,603	16,630	25,998	-7,605	-22.6%
200 and over	39	78,975	30,612	66,155	25,642	-4,969	-16.2%
Total	10,149	2,551	258,947	2,157	218,908	-40,039	-15.5%

Note: All figures are in 1996 dollars.
Source: Heritage calculations from March 1997 *Current Population Survey.* Flat Tax Income includes wages and salary, unemployment compensation, employer contribution to health care and income from pensions.

- The median income of Hispanic households, at $24,906, was 67 percent that of white households;[11]
- 20.9 percent of Hispanic families were "working poor," compared with 6.6 percent of white families;[12]
- Personal savings of the average-income Hispanic family amounted to about one-third that of the average-income family in the general population;[13] and
- Hispanic males earn 81 percent of the average national lifetime wage earnings, while Hispanic females earn 58.5 percent of the national average.[14]
- High taxes that discourage savings and reduce economic growth raise additional obstacles for Hispanic-Americans who struggle to achieve at least statistical parity in the American economy. An important way to help those who seek to improve their prosperity would be to make the tax code fair and simple.

Who would benefit from a flat tax? To answer this question, Heritage Foundation analysts used income tax data extracted from the U.S. Bureau of the Census Current Population Survey for March 1997 and the Heritage Individual Income Tax Simulation Model in order to simulate tax payments under a flat tax.[15] The Current Population Survey provided income, demographics, and tax data for 10,149,000 Hispanic taxpayers. Income variables

11. Jonathan Njus, "Social Security, Hispanic Americans, and Proposed Reform," National Council of La Raza, July 1998, p. 4.
12. *Ibid.* "Working poor" refers to persons whose incomes fall at or below the poverty line and who work either part time or part of the year.
13. U.S. Department of Labor, Bureau of Labor Statistics, *Annual Survey of Consumer Expenditures* (1995).
14. Heritage calculations, based on U.S. Bureau of the Census, *Current Population Survey for March 1995.*
15. The Heritage Individual Income Tax Simulation Model employs data by adjusted gross income class extracted from the IRS Public Use File for 1994. Additional information about the model is available from the authors. See U.S. Bureau of the Census, *Current Population Survey for March 1997.*

Table 4 B 1227

Flat Tax at 17% Compared to Current Law For Hispanics Filing Joint Tax Returns

Flat Tax Income in Thousands of Dollars	Number of Tax Returns in Thousands	Tax Liability Under Current Law: Mean Liability	Tax Liability Under Current Law: Sum (Millions)	Tax Liability under Flat Tax: Mean Liability	Tax Liability under Flat Tax: Sum (Millions)	Change in Tax Liability: Sum (Millions)	Change in Tax Liability: Percentage Change
Zero or less	19	$7,397	$1,435	$0	$0	-$1,435	-100.0%
0 to under 10	411	44	180	0	0	-180	-100.0%
10 to under 15	449	65	290	0	0	-290	-100.0%
15 to under 20	519	234	1,214	0	0	-1,214	-100.0%
20 to under 25	444	488	2,165	81	36	-1,805	-83.4%
25 to under 30	401	1,138	4,570	335	134	-3,226	-70.6%
30 to under 40	640	2,042	13,076	1,012	648	-6,595	-50.4%
40 to under 50	488	3,346	16,323	2,577	1,257	-3,749	-23.0%
50 to under 75	668	6,035	40,297	5,501	3,673	-3,568	-8.9%
75 to under 100	221	12,938	28,585	9,823	2,170	-6,882	-24.1%
100 to under 200	139	22,065	30,712	16,535	2,302	-7,697	-25.1%
200 and over	37	78,131	29,116	65,215	2,430	-4,813	-16.5%
Total	4,437	3,785	167,964	2,851	12,651	-41,454	-24.7%

Note: All figures are in 1996 dollars.
Source: Heritage calculations from March 1997 *Current Population Survey.* Flat Tax Income includes wages and salary, unemployment compensation, employer contribution to health care and income from pensions.

from the Survey were employed to create a tax base for the flat tax similar to that described in H.R.1040, the flat tax legislation recently proposed by Representative Richard Armey (R–TX). This tax base consists of wages and salaries, unemployment compensation, employer-provided health care benefits, and income from previously untaxed pensions and other retirement income streams. Each adult taxpayer was given a $10,000 allowance, and each child of a taxpaying family received a $6,000 allowance. Thus, a married couple with two children making $50,000 in income would deduct $32,000 from that amount to determine their taxable income. The Heritage model then taxed this income at a flat 17 percent rate.

Using the Survey data, the Heritage analysis applied this formula to Hispanic-Americans. Table 3 compares tax payments under current law to those under a flat tax for all Hispanic-American taxpayers. Under a flat tax:

- About 2,390,000 Hispanic-American taxpayers (24 percent) would fall off the tax rolls;
- The average tax payment for Hispanic-Americans would drop by nearly $400 or 16 percent; and
- Middle-class Hispanic-Americans would see their tax payments drop by an average of 9.5 percent.

Nearly 44 percent of all Hispanic taxpayers file joint or married returns. Due to the presence of children in these households, the flat tax would produce even more significant changes in tax payments (see Table 4):

- Nearly 1,400,000 Hispanic married taxpayers would see their tax payments reduced to zero; and
- Average tax payments would drop by $930, or by 25 percent.

HOW HISPANIC AMERICANS WOULD BENEFIT FROM SOCIAL SECURITY REFORM

Social Security's low rate of return means that Americans see fewer potential retirement savings. If Americans were allowed to direct some of their payroll taxes into safe investment accounts similar to 401(k) plans, or even into U.S. Treasury bonds, they would accumulate far more money in savings for their retirement years than they are likely to receive from Social Security.

For example, a single Hispanic-American male born in 1975 who earned the average income for that age group—about $17,900 in wage, salary, and self-employment income in 1996—can expect to receive an annualized real rate of return from Social Security of just 1.44 percent. By contrast, he could expect to receive a long-run real rate of return of at least 2.8 percent from long-term U.S. Treasury bonds. This seemingly small difference in the rate of return translates into thousands of dollars more in funds for retirement than Social Security will pay.[16]

Social Security also has a very low rate of return for two-income Hispanic-American households with children. A double-income Hispanic couple with two children, if they were born in 1965 and earned the average wage received by Hispanic-Americans,[17] can expect a rate of return of 2.17 percent from Social Security over their lifetime. This rate contrasts with a return of 3.17 percent over the same period on an ultra-conservative portfolio composed of 100 percent U.S. Treasury bonds, or a return of 4.67 percent on a prudent portfolio of 50 percent broad market equities and 50 percent U.S. Treasury bonds. In terms of 1997 dollars, this couple could expect to receive $347,000 more in lifetime after-tax income from a portfolio composed equally of government bonds and broad market equities than it could from Social Security.

The low rate of return also has a damaging impact on communities. To understand how, consider a hypothetical city populated by 50,000 young, married, double-earner Hispanic couples in their thirties, in which each person earned the average wage for Hispanics and each couple had two children. The cumulative amount these couples could save by retirement by investing in private pension plans, with the same dollars they currently pay in Social Security taxes, is more than $12.8 billion greater in 1997 dollars than what they will receive from Social Security. This amount is roughly equal to half of what the federal government currently spends on food stamps each year and half as much as direct federal spending on education.[18]

Crowding Out Savings

Social Security's poor rate of return should be important to anyone interested in planning for an adequate retirement income in old age. If the rate nearly equals what one could achieve from stocks and bonds, then it makes sense to devote current savings to things other than retirement savings. But retirement rates of return from Social Security are significantly poorer than returns from bonds or stocks, even after adjusting for inflation and risk; therefore, additional current savings need to be allocated to future retirement needs.

Defenders of Social Security argue that rates of return are irrelevant to the Old-Age and Survivors Insurance (OASI) portions of the program. Social Security, they suggest, was intended to provide a basic, but decent, retirement income to beneficiaries and stopgap incomes for surviving spouses.

16. Based on Heritage calculations, the difference is $40,200. For additional details on how this was calculated, see "Appendix: Basic Assumptions and Methodology," in William W. Beach and Gareth G. Davis, "Social Security's Rate of Return for Hispanic Americans," Heritage Foundation *Center for Data Analysis Report* No. CDA98–02, March 27, 1998.

17. Based on an average wage-based income for a Hispanic worker of $17,911 in 1996, this presumes the couple earned a total of $35,822.

18. Scott A. Hodge, ed., *Balancing America's Budget: Ending the Era of Big Government* (Washington, D.C.: The Heritage Foundation, 1997).

Future Social Security beneficiaries, they argue, should be saving now for additional retirement income to supplement benefits from OASI. Thus, they contend, comparing rates of return on private pension investments with those from a public program intended to pay out during retirement at least 35 percent of the wages an average worker earned prior to retirement is like comparing apples to oranges.[19]

Such reasoning, however, has a fundamental flaw: If Social Security taxes were low enough to *allow* workers to save these additional dollars for their retirement, then conceivably Social Security would be the pension program of last resort; but Social Security taxes are *not* low, and they in fact crowd out the ability of most low- and middle-income Americans to save for retirement. Thus, the rate of return on these taxes is very important, especially for those Americans for whom Social Security is the primary source of retirement savings.

Over the past 25 years, Congress and the President have increased Old-Age and Survivors benefits so often and so much that the high payroll taxes needed today to pay those current benefits crowd out private retirement investments.[20] In 1972, the average worker (with his or her employer) paid 8.1 percent in Old-Age and Survivors payroll taxes on the first $9,000 of wages and salary (equivalent to about $21,500 in 1997 dollars).[21] In 1997, that worker paid 10.7 percent on the first $65,400 of "earned" income (or the first $27,340 in 1972 dollars).[22]Moreover, between 2020 and 2046, the Old-Age and Survivors tax rate will have to rise to 14.4 percent from today's 10.7 percent if benefit costs are not cut.[23]

Because of rising payroll taxes for Social Security, increasing numbers of poor and middle-income workers do not have after-tax funds to create private supplemental pension investments.[24] In fact, today, Social Security taxes consume as much of the average family's budget as do outlays for housing, and nearly three times more than annual health care expenses.[25]

Further, because of the long-term financial problems of the Social Security trust fund, today's calculations of the rate of return for Social Security are likely to prove optimistic for future generations. The fact is that Social Security will not be able to pay out old-age benefits to the "baby

19. See Social Security Administration, "Findings and Recommendations," *1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Communication from the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, House Doc. 104–228 (Washington, D.C.: U.S. Government Printing Office, 1997), Table R1, p. 36.

20. See Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," *A.E.A. Papers and Proceedings*, May 1996, pp. 1–14.

21. Social Security Administration, *1997 Annual Report of the Board of Trustees*, Table II.B1, pp. 34–35. Wages and salaries are taxed to support the Old-Age and Survivors and Disability Insurance programs (Social Security taxes), with 50 percent paid directly by the employee and 50 percent by the employer on the employee's behalf. The employer's half comes from wages the family would have earned had there not been a payroll tax.

22. Taxable threshold levels for 1972 and 1997, adjusted by the index value for the Consumer Price Index, All Urban Series. See *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1997), Table B-58, p. 365.

23. Heritage Foundation estimates based on data from Social Security Administration, *1997 Annual Report of the Board of Trustees*, Table II.F14, p. 112.

24. This is complicated by the decreasing number of firms that provide company pensions to their workers. Rising taxes of all kinds, costly regulations, and increasing pressures on the bottom line have caused many firms to avoid the practice of providing pensions for long-time employees.

25. Data on average family consumption expenditures from U.S. Department of Labor, Bureau of Labor Statistics, "Consumer Expenditures in 1995," June 1997, Table A. This report estimates average family income before taxes to be $36,918. Heritage analysts added $2,289 to reflect additional wages the average worker would receive if the employer's share of Social Security were converted to wages.

boom" generation without additional tax increases on workers or cuts in benefits. These tax increases or benefit cuts will further reduce the Social Security rates of return for those workers currently in their twenties (members of the so-called Generation X) and their children. As Social Security's rates of return fall, the relevance of rates of return on private pensions rises. That is, members of Generation X simply will not be able to ignore the prospect of inadequate income during their retirement years. Comparing rates of return for private and public pensions will become even more important to subsequent generations.

Few aspects of Social Security are as unintended or as damaging to low- and middle-income workers as the squeeze that high payroll taxes put on the formation of intergenerational transfers of wealth. The inability of low-income workers to accumulate enough savings to leave a sufficient nest egg to their children may mean that their children will be as dependent on a monthly Social Security check as their parents are. It means that poor communities will not have as much "home-grown" capital available with which to create new jobs and sources of income. Without these jobs and income, members of the next generation will be less able to save for retirement. Thus, by taxing away one generation's opportunity to help the next generation earn income at a higher level, the Social Security system acts as a drag on the prosperity of future generations.

Social Security's Rates of Return for Hispanic Families

The ability of individuals to make the important decision to invest in bonds or stocks depends on how clearly they can see their prospective retirement rate of return from Social Security. The declining rates of return and mounting tax burdens implied by the current system disproportionately affect the comparatively youthful Hispanic population. Social Security tax rates would have to increase by about 40 percent between now and 2050 just to keep the system solvent. The U.S. Bureau of the Census estimates that Hispanics will comprise almost 25 percent of those in the economically active 18- to 66-year-old population in 2050 (compared with 11 percent in 1997), but only 17 percent of those aged 67 and over. In other words, the burden of paying Social Security retirement benefits will be borne increasingly by Hispanic workers.[26]

To demonstrate actual Social Security benefits for Hispanic-Americans, Heritage Foundation estimates of rates of return refer only to that portion of Social Security that provides retirement income. Heritage analysts removed the non-retirement components of Social Security by subtracting pre-retirement survivors' benefits and taxes that support this separate insurance program from the rate-of-return calculations. Similarly, Heritage analysts did not include disability insurance taxes or benefits in its retirement rate of return estimates. Heritage also assumes that both the survivors' and disability programs will continue unaffected by the privatization of the retirement portion of payroll taxes.[27]

Heritage Foundation analysts calculated Social Security's inflation-adjusted (or "real") rates of return for various segments of the Hispanic population, and then compared these returns with the rates of return workers could receive if they were allowed to invest their Social Security taxes in safe, private retirement investments.[28] These calculations show that Hispanic families of many types receive relatively low returns for the lifetime taxes they pay.[29]

Social Security's formulae are designed expressly to redistribute income toward retirees with average- and low-income work histories. Yet single-earner, average-income couples born before 1935, who have paid much lower lifetime payroll taxes, fare better than do much younger workers. How-

26. Heritage calculations based on U.S. Bureau of the Census, *Population Projections for the United States, 1995–2050* (Washington, D.C.: U.S. Government Printing Office, 1996), at *www.census.gov/population/www/projections/natproj.html*.

27. See "Appendix: Basic Assumptions and Methodology," in Beach and Davis, "Social Security's Rate of Return for Hispanic Americans," for details on the Heritage model methodology.

ever, even the "best case" rate of return (4.9 percent for a single-earner couple with children in which the worker was born in 1932) lies below 7 percent, a conservative estimate of what economists consider is the long-range real rate of return on equities.[30] Every other average-income group lies *below* this rate of return, or well below the rates of return available to Americans who invest in stocks and bonds for the long term.

Double-earner, average-income families, as well as single, average-income males and females, fare poorly under Social Security. Average-income, single Hispanic males are hit particularly hard because of the lower life expectancy of males and the absence of spousal and survivors' benefits. The expected real rate of return from Social Security for average-income males falls from a high of 3.4 percent for those born in 1935 to 1.4 percent for those born in 1975, well below what could be realized from a prudent private investment portfolio.

What Do These Rates of Return Mean in Dollar Terms?

Because of the power of compound interest, even what appears to be a relatively small difference in the real rate of return can have significant implications for a Hispanic family's lifetime accumulated wealth. In order to analyze the dollar implications of Social Security's lower rate of return, Heritage analysts calculated the inflation-adjusted differences between Social Security's benefits and what a fairly conservative investor could accumulate by retirement from a portfolio split equally between long-term U.S. Treasury bonds and broad market equity funds.

An average-income, two-earner couple (both aged 32 years in 1997) with two children can expect to receive about $420,400 in Social Security benefits in return for a lifetime of payroll taxes. Investing these same tax dollars in a portfolio made up of 50 percent U.S. Treasury bonds and 50 percent blue-chip equities, however, could command an estimated $767,100 of after-tax retirement income for this couple in 1997 dollars.[31] Even an investment portfolio composed entirely of intermediate and long-term U.S. Treasury bonds outperforms Social Security: By the time of retirement, this couple would generate a lifetime retirement post-tax income of $526,400.

Hence, staying in the Social Security program costs an average-income, married Hispanic couple in this age group between $106,000 and $346,700 in retirement savings that they could have enjoyed if current law gave them the ability to invest their payroll taxes in super-safe U.S. Treasury bonds or in a prudent mix of Treasury bonds and high-

28. Heritage Foundation analysts reduced all rates of return and related calculations presented in this paper by the annual rates of inflation for the years between 1997 and 2040 as forecast by the Board of Trustees of the Social Security Old-Age and Survivors Insurance Trust Fund in its 1997 annual report. This adjustment to rates of return, Social Security benefits, and privately managed savings means the reader always is shown sums and earnings ratios in terms of a dollar's purchasing power today. Thus, the statement "Social Security will pay out an annual amount of $17,000 in the year 2040" means that the program will pay enough to allow a beneficiary to purchase then what $17,000 will purchase now. In order for a beneficiary to have as much "purchasing power" in the year 2040 as he has today, Social Security actually would have to send him around $100,000 annually. The difference between the two amounts is explained by the effects of inflation on the dollar's value, or by what a dollar would buy in 2040 after years of decreasing value due to inflation.

29. Generally, an average-income earner is defined in Social Security Administration simulations as someone who earns the average income of the working population, which the Social Security Administration estimated in 1996 to be $25,723. The average income for Hispanic workers, which is used in the calculations contained in this paper, was 69.63 percent of this amount, or $17,911 in 1996. U.S. Department of Labor, *Usual Weekly Earnings of Wage and Salary Workers in 1997* (Washington, D.C.: U.S. Government Printing Office, 1998).

30. *Report of the 1994–1996 Advisory Council on Social Security, Vol. I: Findings and Recommendations*, p. 35.

31. These amounts reflect the buildup of retirement savings in tax-deferred individual retirement account-type investment portfolios until the age of retirement. Following retirement, it is assumed that the couple annuitizes its savings over 26 years at a real interest rate of 2.0 percent. These amounts are net of all federal income taxes.

grade equities. These dollar differences translate into significant differences in rates of return. Social Security "produces" a 2.17 percent inflation-adjusted rate of return for this couple. If the couple invested their payroll taxes entirely in Treasury bonds, however, they would receive a return rate of 3.17 percent, while an even mix of bonds and equities would produce an annualized return of 4.67 percent.

The gains under a mixed portfolio are such that this average-income Hispanic-American couple could create an annuity out of their retirement savings that paid them as much each month as Social Security would, and still have approximately $205,000 left in their accumulated savings at age 67 to bequeath to their children.[32] This amount could be used to start a business, pay for education or health care, or to seed the retirement security of the next generation.

CONCLUSION

To realize the economic potential inherent in American communities, regardless of their ethnic composition, involves much more, of course, than changing government programs. Parents and community leaders know well the vital role that individual responsibility, ethical behavior, and equal treatment before the law can play in achieving economic prosperity. Too often throughout this century, Americans have turned to the federal government as a way to ensure their economic improvement.

Now, at the end of the 20th century, the problems of that reliance on government are evident. As the progeny of the Great Society parse through its public policies, they are saving the valuable and attempting to eliminate or reconstruct those that work against their social and economic well-being in the long run. Congress and the President are faced with making fundamental reforms in education and tax policy as well as Social Security in light of that effort.

Unleashing the economic potential of all Americans, and especially Hispanic-Americans, will require many things: changing current education policy, lifting the heavy and growing tax burden from the shoulders of hardworking Americans, and permitting workers to invest a portion of their payroll taxes in bond and stock portfolios to build income for retirement and their children's future. Such changes in key federal policies can enable *all* Americans to use their individual talents to achieve greater economic rewards and individual well-being in the coming decades.

—William W. Beach is John M. Olin Senior Fellow in Economics and Director of The Center for Data Analysis at The Heritage Foundation. Gareth G. Davis and Kirk Johnson are Policy Analysts, and Rea S. Hederman is a Research Analyst, in The Center for Data Analysis. Nina Shokraii Rees is Education Policy Analyst at The Heritage Foundation.

32. Heritage Foundation calculation based on real interest rate of 2.0 percent.