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Calculating Social Security's Rate of Return

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Since January 1998, when The Heritage Foundation published its first Center for Data Analysis (CDA) study analyzing Social Security's rate of return, President Bill Clinton and a variety of experts have argued that Social Security's rate of return needs to be higher. The opponents of reform, however, continue to claim that Social Security provides a good rate of return in retirement income benefits for the payroll taxes that workers pay. So they have had to criticize Heritage's methodology as flawed. But these claims are spurious, as we demonstrate in our recent *CDA Report*, "Social Security's Rate of Return: A Reply to Our Critics" (No. 98–08). For example:

The Cost of Transitioning to a New System: Opponents have argued that Heritage does not take into account the cost of the transition to a system of private Social Security accounts.

Response: Heritage's rate of return analysis is a benchmark measurement of the performance of the current Social Security system that is based on the Social Security Administration's (SSA) own estimates of the program's future costs. It does not propose or cost out an alternative plan.

The Method of Calculating the Rate of Return: Some critics argue that Heritage overestimates the expected number of years a person will work and underestimates the number of years a person will live after he retires, which would underestimate the rate of return.

Response: There are several ways to calculate Social Security's rate of return. Each method has advantages and disadvantages. We used a method based on *average life expectancies,* which involves calculating how long an average member of a particular group is expected to live, and then calculating the return from Social Security for a worker who lives to that life expectancy.

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Our critics mainly favor the *expected value method,* which involves adding up all of the expected benefits paid and taxes collected year by year. Unfortunately, this method is very susceptible to distortion by skewed data. Many actuaries, especially those in the private sector who advise clients on investment options for retirement, recognize the weaknesses of this method and routinely use the method we chose in analyzing investment options.

Some critics have their facts wrong. For example, former Social Security Chief Actuary Robert Myers mistakenly claims that Heritage uses a life expectancy of exactly 69 years for a 21-year-old African-

American male. In fact, we use a life expectancy of 73.81 years, which takes into account probable improvements in life expectancy that would increase the rate of return for these Americans.

The Center on Budget and Policy Priorities used a table of life expectancies for 20-year-old white and black males in 1997 that purportedly was developed from Heritage's study. Its table refers to examples that are not even computed in the Heritage study, however, and the data are drawn from a different source that—unlike the refined data Heritage uses—does not take into account the likely improvements in future life expectancy that Heritage factors into its analysis.

Even studies using different methods agree that, for African-American workers, Social Security offers a worse deal than it does for white workers with identical incomes and family structure. For example, when Heritage uses the data and methodology of one of its critics, Deputy Chief Actuary of the SSA Steve Goss, the rates of return for 20-year-old white and black male workers are 0.59 percent and -0.15 percent, respectively.

Excluding Disability Insurance: Critics have charged that Heritage's rate of return is understated because Heritage includes Disability Insurance (DI) taxes in its analysis but not the cost of disability benefits.

Response: This is simply wrong. Both DI taxes and benefits are excluded from the Heritage analysis. Heritage also carefully accounts for pre-retirement Survivors' Insurance by excluding the taxes necessary to purchase this insurance. Both benefits are retained exactly as they exist under current law.

The Assumed Rate of Return on Private Investments: Opponents have charged that Heritage exaggerates the benefits of a privately held individual account by assuming too high a rate of return on private investments.

Response: For the years up to 1997, Heritage uses the actual annual historical rates of return on bonds and equities. For 1998 and future years, the real rate of return on equities is assumed to be 5.7 percent, well below the SSA's projection of 7 percent. The real rate of return on bonds is projected to be 2.8 percent—the same projection the SSA uses.

Administrative Costs: Critics charge that high annual administrative costs, of 1.5 percent to 2 percent of assets, would eliminate most or all of the gains from privatization.

Response: Administrative costs would be much lower. A 1996 U.S. Department of Labor study shows that the administrative costs for private-sector, multi-employer defined contribution plans are only 0.82 percent of assets. The mean administrative cost for Standard & Poor's 500 Index mutual funds, according to Lipper Analytical Services, is 0.39 percent. And the new 30-year Series I Savings Bonds, which currently pay a return of 3.3 percent over the inflation rate, can be obtained with no administrative cost.

The Employer's Share of Payroll Taxes: Heritage includes both the employee's share of taxes and those paid by the employer, which overestimates the cost of the program to workers.

Response: Heritage agrees with Dean Leimer, chief author of the SSA's rate of return calculations, who says, "Ignoring the employer share of the tax is clearly inappropriate, because it results in the comparison of benefits with taxes that are insufficient to fund those benefits; as a consequence, Social Security appears to be a much better deal than it actually is when all taxes required to fund the program are considered."

Conclusion. Thus, none of these criticisms offers information that would alter Heritage's basic finding: *Social Security offers a very low rate of return for most Americans, including minorities and low-income families.*

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