Executive Summary
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Social Security Reform Is Crucial for Small-Business Entrepreneurs

James Morrison, Ph.D.

With a national discussion underway about reforming Social Security, it is timely to consider the impact of possible changes on the nation's small businesses and entrepreneurs. Well-crafted reforms could aid this vital sector, but a survey of economic research shows that quick fixes like payroll tax hikes could be extremely damaging—not only to entrepreneurship, but also to the economy's ability to generate the jobs and growth needed to sustain Social Security.

Principles for Reform. Taken together, the studies reviewed here suggest five important principles for retirement policy and Social Security reform:

1. Efforts to *expand pension coverage* are unlikely to succeed unless the coverage is significantly tax-advantaged and easily administered, employer contributions are minimized, and the overall economic climate is positive.
2. Simply providing *new opportunities to save* will not solve the retirement income dilemma. Individuals already have many attractive ways to save for retirement. These opportunities are underutilized by many middle-income and lower-income citizens, who say that they do not have enough money left to save for retirement after they pay for their basic needs.
3. *Social Security benefits* are likely to be a more important source of retirement income for entrepreneurs and those who work in smaller companies than for other Americans.
4. Some way must be found to *sustain and, if possible, increase retirement benefits*—one that does not increase payroll taxes and does not assume that voluntary contributions will be made to a savings plan simply because that plan exists.
5. *Raising taxes on entrepreneurs* is not the way out of the dilemma. If Congress tries to "solve" Social Security's financial problems by raising marginal tax rates, there will be fewer entrepreneurs. If there are fewer entrepreneurs, there will be fewer new jobs created and slower economic growth. With fewer jobs and slower growth, Social Security's problems will become far worse.

The Best Reform Option for Entrepreneurs. Of all the Social Security reform proposals currently being discussed, the one that best fits all of these criteria is diverting a portion of existing payroll taxes into personal accounts that workers would own and control themselves. There are several key reasons for this.

- Personal accounts that are developed from existing payroll taxes would likely increase Social Security benefits while avoiding payroll tax

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increases. This meets two of the entrepreneur's needs simultaneously. It could decisively improve the rate of return that entrepreneurs would achieve for their own retirements, and it could help to avoid marginal tax increases that would create an unfavorable economic climate for entrepreneurial activities. Both factors would create strong incentives for entrepreneurship.

- The personal account option would *not* require the entrepreneur, as an employer, to increase the contribution level for employee pensions or savings funds. Yet personal accounts would likely offer those employees a better rate of return than they could expect from the existing Social Security system. This would make *working for* an entrepreneurial business—even one without a pension plan—a more attractive option for potential employees.
- The personal account option directly addresses the two key structural flaws in the current system: the demographic squeeze of fewer workers supporting more retirees for longer periods of time and the huge unfunded liability. Payroll tax increases would not fundamentally address either structural problem. Under a personal account system, benefits would rise as the value of investments rose. The benefits would not depend on the forbearance of workers under ever-heavier tax burdens or on some unlikely spurt of population growth. Moving toward pre-funding Social Security and paying down unfunded liabilities are important steps in reducing the downstream pressure for higher taxes.
- Since personal accounts would create assets that could be passed on to heirs, the number of individuals receiving inheritances would rise. This would aid the retirement income prospects of the *next* generation. Research has also shown that individuals receiving inheritances are far more likely to engage in entrepreneurial activities than is the population as a whole. Thus, personal accounts, in and of themselves, would indirectly increase entrepreneurship.
- Because entrepreneurs focus on economic risks, they are likely to make informed choices about whether or not to choose personal accounts and to convey their thinking to their employees. This kind of constructive scrutiny will be good for the system. However, entrepreneurs will also understand, and be accepting of the fact, that some people may choose the "known" of the traditional Social Security system over the relative "unknowns" of personal accounts.
- A personal account system would help to curtail the current practice of having the Treasury Department cover its borrowing from the Social Security system by issuing non–publicly traded government securities (IOUs) to that system. In contrast to this practice, personal account funds would be invested in private and public equities markets, where money is substantially more transparent and fungible. Over time, therefore, personal accounts would likely increase the capital available for entrepreneurial ventures.

Conclusion. Personal accounts offer two fundamental advantages for small business: actions that the government would *not have to take* (unnecessarily raising taxes or cutting Social Security benefits) and results that the private sector *would* generate (enhanced entrepreneurship, strengthened capital markets, and improved retirement incomes). In the end, empowering entrepreneurs in this way would benefit the entire nation as additional jobs were created and economic growth was sustained.

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Why Focus on Small Business and Entrepreneurship?

Small business exercises an immense influence on the American economy. More than 99 percent of all U.S. employers are small, and they employ just over half the private sector workforce. Such firms provide about three-quarters of the nation's net new jobs and half of its private-sector economic output. During recoveries from recent recessions, small businesses have been even more crucial, supplying virtually all of the net new jobs. For example, in 2000–2001, the nation's largest companies suffered a net loss of over 150,000 jobs. During the same period, companies with fewer than 20 employees created over 1.1 million net new jobs.[1]

However, job and output statistics alone tell only part of the story. While larger businesses tend to create *process* innovations that strengthen economic efficiency, smaller businesses and entrepreneurs are responsible for the lion's share of *product* innovations that create new businesses and industries.[2] Technological developments that appear likely to play a cen-

Talking Points

- Small businesses employ just over half the private-sector workforce and provide about three-quarters of the nation's net new jobs and half of its private-sector economic output.
- Self-employment and other forms of entrepreneurship are highly sensitive to tax rates and other macroeconomic factors, including Social Security payroll taxes.
- Raising Social Security taxes would threaten entrepreneurship, small business, and job creation, which would in turn threaten the nation's economic growth as well as Social Security's own long-term revenue projections.
- Pre-funding Social Security through personal retirement accounts would (1) likely increase benefits while avoiding major payroll tax increases; (2) directly address the two key structural flaws in the current system (demographic squeeze and the huge unfunded liability); and (3) create assets that could be passed on to heirs.

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tral role in future U.S. economic growth—such as biotechnology, nanotechnology, homeland security technology, and breakthrough innovations in information technology—have been closely linked to smaller companies.

This is an unusual feature of the American economy,[3] but it is not a new feature. Of the 200 largest American companies in the late 1990s, 197 could be traced back to entrepreneurial founders, according to one study.[4]

Small firms are also breaking paths in the rapidly globalizing economy. Between 1987 and 2003, the number of U.S. small-business exporters tripled to over 240,000, and these companies were 20 percent more productive, experienced 20 percent faster job growth, and paid 15 percent higher wages than the rest of American business.[5]

At the same time, small business traditionally has offered a way into the economic mainstream for younger and less-skilled workers, the economically displaced, immigrants, and people leaving public assistance. In every American community, small firms present the most vivid human face of the economic system.

Consequently, Americans have great respect for small businesses. A Gallup poll found large majorities agreeing that small business represents "one of the best ways to get ahead in America" and saying that they strongly admired small-business owners. Indeed, 90 percent said they would be pleased if a son or daughter started a small business.[6] Surprisingly large majorities say that small-business owners work harder (91 percent) and contribute more to the community (82 percent) than "people like yourself" do.[7] These survey findings are essentially constant across age, ethnicity, gender, socioeconomic status, rural/suburban/urban characteristics, political philosophy, and partisan identification, and they are far more positive than comparable survey results from abroad. These public attitudes help to explain the deep reserves of support that small business enjoys in Congress, state legislatures, and other governmental institutions.

Economic studies bear out the public perceptions about the value of smaller companies and the characteristics of the individuals who propel them. For example, economist William Bradford found that "black and white entrepreneurs have more upward and less downward mobility in the wealth distribution [of the U.S.] than black and white workers, respectively."[8] Similarly, economist Vicenzo Quadrini found that entrepreneurs do in fact accumulate more assets and savings and generate more

1. The figures cited are for net job creation by firm size (subtracting job losses from job gains) covering the 2000–2001 period. They show that businesses with one–19 employees created 1.1 million net new jobs, businesses with 20–500 employees created 39,000 net new jobs, and businesses with more than 500 employees lost a net 151,000 jobs. See U.S. Department of Commerce, Bureau of the Census, "Establishment and Employment Changes from Births, Deaths, Expansions, and Contractions by Employment Size of the Enterprise for the United States and All States, Totals: 2000–2001," data type code 11, columns D–J, at *www.census.gov/csd/susb/usst00_01.xls* (May 19, 2005). Over the past 15 years, the proportion of net new jobs created annually by small business has ranged from 64 percent to 100 percent, averaging about 77 percent, and the proportion of U.S. gross domestic product attributable to businesses with fewer than 500 employees has ranged from 49 percent to 52 percent. See Joel Popkin, "Small Business Share of Economic Growth," U.S. Small Business Administration, Office of Advocacy, *Small Business Research Summary* No. 211, January 2002, at *www.sba.gov/advo/research/rs211.pdf* (May 19, 2005).
2. Zoltan Arcs and David Audretsch, *Innovation and Small Firms* (Cambridge, Mass.: MIT Press, 1996).
3. Richard Nelson, *National Innovation Systems* (Oxford, U.K.:, Oxford University Press, 1993).
4. Courtney Purrington and Kin Bettcher, *From the Garage to the Boardroom: The Entrepreneurial Roots of America's Largest Corporations* (Washington, D.C.: National Commission on Entrepreneurship, 2001).
5. U.S. Department of Commerce, Office of Trade and Economic Analysis, Exporter Data Base.
6. William J. Dennis, Jr., *The Public Reviews Small Business* (Washington, D.C.: NFIB Education Foundation, August 2004), p. 17. The figure is based on a 2004 poll of 750 American adults.
7. *Ibid.*, pp. 21–22.

wealth than other individuals at their same income levels.[9] An array of studies has confirmed that the actions and decisions of entrepreneurs spearhead most new job creation.[10]

The good news is that there is enormous latent entrepreneurship in the United States. A 1998 survey of 25,000 individuals in 23 nations found that an amazing 71 percent of U.S. respondents said that they would prefer to be self-employed.[11] Even if half of these individuals were not truly serious about self-employment, the total is still many times larger than the 10 percent or so of Americans who are in fact self-employed.

The bad news is that self-employment and other forms of entrepreneurship are highly sensitive to tax rates[12] and other macroeconomic factors, such as the tax treatment of retirement benefits,[13] including Social Security payroll taxes.

The challenge facing the country is that current levels of Social Security benefits are not sustainable using the system's present financing. Previous efforts to shore up Social Security's financing have focused primarily on increasing the number of individuals and types of wages covered by payroll taxes and on increasing payroll tax rates.

The research reviewed here strongly suggests that if such measures are the central thrusts of the next overhaul, Social Security taxes would likely become a far larger threat to entrepreneurship, small business, and job creation, which would in turn threaten the nation's economic growth as well as Social Security's own long-term revenue projections.

Marginal Tax Rates and the Entrepreneur's Decision

To understand why this is true, it is crucial to grasp the role of marginal tax rates.

8. William D. Bradford, "The Wealth Dynamics of Entrepreneurship for Black and White Families in the US," *Review of Income and Wealth*, Vol. 49, No. 1 (March 2003), pp. 89–116.

9. Vicenzo Quadrini, "The Importance of Entrepreneurship for Wealth Concentration and Mobility," *Review of Income and Wealth*, Vo. 45, No. 1 (March 1999), pp. 1–20.

10. For example, see Zoltan Acs and Catherine Armington, "Job Flow Dynamics in the Service Sector," U.S. Department of Commerce, Bureau of the Census, Center for Economic Studies *Research Paper* No. 99–14, 1999; Catherine Armington, Alicia Robb, and Zoltan Acs, "Measures of Job Flow Dynamics in the U.S.," Department of Commerce, Bureau of the Census, Center for Economic Studies *Research Paper* No. 99–1, 1999; John Baldwin, Timothy Dunne, and John Haltiwanger, "A Comparison of Job Creation and Job Destruction in Canada and the United States," *Review of Economics and Statistics*, Vol. 80, No. 3 (August 1998), pp. 347–356; David Birch and James Medoff, "Gazelles," in Lewis Solomon and Alec Levenson, *Labor Markets, Employment Policy and Job Creation* (Boulder, Colo., and London: Westview Press, 1994), pp. 159–165; and Robert E. Hall, "The Concentration of Job Destruction," National Bureau of Economic Research *Working Paper* No. 7025, 1999.

11. David Blanchflower, Andrew Oswald, and Alois Stutzer, "Latent Entrepreneurship Across Nations," *European Economic Review*, Vol. 45, Nos. 4–6 (May 2001), pp. 680–691. The survey source was the International Social Survey Programme Module on Work Orientations. Poland ranked highest, with 80 percent saying that they preferred self-employment, and Portugal was second, with 73 percent. Self-employment was favored by a majority of respondents in 11 of the 23 nations and by near majorities in three others. Norway ranked last, with a still remarkable 27 percent saying they preferred self-employment—more than four times that nation's actual self-employment rate.

12. Donald Bruce, Ph.D., and Tami Gurley, "Taxes and Entrepreneurial Activity; An Empirical Investigation Using Longitudinal Tax Return Data," U.S. Small Business Administration, Office of Advocacy *Research Study* No. 252, March 2005, at *www.sba.gov/advo/research/rs252tot.pdf* (May 19, 2005); Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Personal Income Taxes and the Growth of Small Firms," in James Poterba, ed., *Tax Policy and the Economy*, Vol. 15 (Cambridge, Mass.: MIT Press, 2001), pp. 121–147; William Gentry and R. Glenn Hubbard, "Tax Policies and Entrepreneurial Entry," *American Economic Review*, Vol. 90, No. 2 (May 2000), pp. 283–287; Roger H. Gordon and Julie Berry Cullen, "Taxes and Entrepreneurial Activity: Theory and Evidence for the U.S.," National Bureau of Economic Research *Working Paper* No. 9015, 2002; and Simon C. Parker and Martin T. Robson, "Explaining International Variations in Self-Employment: Evidence from a Panel of OECD Countries," *Southern Economic Journal*, Vol. 71, No. 2 (June 2004), pp. 287–301.

13. Laura Power and Mark Rider, "The Effect of Tax-Based Savings on the Self-Employed," U.S. Department of the Treasury, Office of Tax Analysis *Paper* No. 84, July 1999.

For an entrepreneur contemplating a business venture, a central question is what the *marginal tax rate*—the so-called tax on the "next dollar of profit"—will be. Entrepreneurship obviously entails risks, and an entrepreneur will not take them without a "risk premium"—in other words, without rewards that are seen as appropriate.[14]

For example, in a hypothetical but relatively typical entrepreneurial situation, a business opportunity appears for an individual who is a wage-earner. That opportunity seems likely to yield $100,000 in taxable profit (after expenses and deductions) in the next tax year. To participate in the opportunity, the entrepreneur would need to sell some securities or perhaps take out a second mortgage on a home. The risk for the entrepreneur is that these assets must be pledged toward a business whose future success is ultimately based on educated guesses.

By contrast, the taxes facing the entrepreneur—the "subtractions" from the return that the opportunity can offer—are the most knowable parts of the entrepreneur's calculation. Assuming that the entrepreneur weighing this $100,000 opportunity acts as a sole proprietor, a partner, or part of a "pass-through" entity like an S corporation or an LLC, the tax calculation might look like this:

1. **Federal income taxes.** The "business opportunity" income would likely fall into the 28 percent personal income tax bracket, assuming that the entrepreneur's other wage income does not push the entrepreneur into the 35 percent bracket.
2. **State income taxes.** These might total 6 percent. Various minor state and local taxes and licenses might add another 1 percent. Nearly all of that 35 percent in state and federal income tax would be contingent on the business's making a profit.
3. **Payroll taxes.** These must be paid whether or not the business makes a profit. For wages up to the $90,000 cap on federal payroll taxes for Social Security and Medicare, the entrepreneur would owe 7.65 percent in payroll taxes on the salary of each wage-earner in the new venture. If the entrepreneur were self-employed in the new venture, the payroll taxes would include an additional 7.65 percent on the entrepreneur's wages for the "employee share," for a total of 15.3 percent. Above the $90,000 cap, this payroll tax would drop to 2.9 percent (for Medicare).

As a result, an entrepreneur weighing this hypothetical opportunity as a self-employment proposition would have to decide whether the prospects looked good enough to pay 15.3 percent in taxes on personal earnings up to $90,000 and, if the business made a profit, another 35 percent in income taxes. If the business opportunity cleared enough to pay the entrepreneur (or any employees) more than $90,000 in salary, there would be a "success reward."[15] The payroll taxes drop to 2.9 percent on wages above that amount, making the marginal tax bite that much smaller on those dollars.[16]

For the prospective entrepreneur, this is a fairly dicey marginal tax rate profile. If there is a "tipping point" in the entrepreneur's "go/no go" decision, anecdotal evidence would suggest it is the 50 percent tax threshold—the level at which entrepreneurs begin grumbling that "the government

14. Douglas Holtz-Eakin, Harvey S. Rosen, and Robert Weathers, "Horatio Alger Meets the Mobility Tables," *Small Business Economics*, Vol. 14, No. 4 (October 2000), pp. 243–274.

15. By eliminating this "success reward," proposals to remove the current $90,000 cap on Social Security taxes would substantially weaken the incentives for entrepreneurial activity in this investment range.

16. The entrepreneur obviously will have to consider other factors besides taxes. Also, if the business loses money, there is some "risk sharing" possible with the federal government in the form of loss carry-forwards and capital losses. But the critical impact of the failure would be felt in the first year by the entrepreneur, however much that failure might lower the entrepreneur's taxes in future years. The taxes also might vary upward, if the alternative minimum tax (AMT) entered the picture, or downward, if various additional business credits and deductions did. The hypothetical example somewhat offsets the latter possibility by stipulating that the income is in the 28 percent bracket rather than a higher bracket. In any event, the example is intended simply as a reasonable hypothetical case for purposes of illustration.

would be getting most of the money." Current marginal tax rate profiles hover very close to that 50 percent mark for many profitable business opportunities that would generate less than $90,000. While the rates drop after that due to the payroll tax cap, they rise again at $319,000 when the "next dollar" of income falls into the 35 percent federal income tax bracket, nudging the marginal tax profile again toward 50 percent.[17]

The other factor that the entrepreneur can know with some certainty is the cost of the money that would finance the transaction. For example, to finance this hypothetical investment opportunity, the entrepreneur could perhaps borrow the money at a 7 percent interest rate or withdraw it from a personal investment that is paying 5 percent. In either case, the entrepreneur would expect the returns from the business opportunity to cover the interest payments (or lost investment opportunity) plus a "risk premium" for taking the risk of pursuing the business opportunity. Any time taxes go up, all other things being equal, fewer entrepreneurial opportunities will offer these risk premiums.

Extending the hypothetical case a bit further, if the $100,000 opportunity required the entrepreneur to bring $300,000 to the table, and if that money cost the entrepreneur 6 percent (or $18,000) in forgone interest or investment income for the year, then the opportunity might need to yield at least $40,000 (13.3 percent) in after-tax profit to justify the risk. "After all," the entrepreneur thinks, "what if the opportunity doesn't work out? I'd be out a piece of the $300,000—maybe a big piece—plus whatever interest income I might otherwise have generated from it. How much of a premium do I need from this opportunity to justify that risk?"

Thus, if about $50,000 of the $100,000 anticipated gain is headed directly to taxes,[18] the margin of error on the business opportunity—whether the error is caused by changes in costs, demand, interest rates, or simply poor management—is small. Eliminating the $90,000 "cap" on earnings subject to Social Security taxation, or raising the overall payroll tax rate, would narrow or eliminate that margin of error.[19] The risks would look increasingly large while the rewards would appear increasingly small.

Calculations like these are not often part of the public debate about economic policy, but they ought to be. They represent key elements that entrepreneurs will weigh before producing the jobs and economic growth that the nation needs.[20]

Social Security's Impact on Marginal Rates

Looking ahead, entrepreneurs may well find themselves nostalgically remembering marginal tax rate calculations like those in the example.

Payroll Tax Increases. Payroll tax increases to support Social Security are very much on the table. According to the Social Security Administration, if Social Security benefits remain on their present course, achieving long-term solvency in Social Security financing through payroll taxes would require a 15 percent increase if enacted now, a 21 percent increase if enacted in 2018, and a 42 percent increase if enacted in 2042.[21]

17. Thus, Martin Feldstein argues that even the current level of Social Security taxation substantially distorts occupational choice and effort. See Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," *American Economic Review*, Vol. 86, No. 2 (May 1996), pp. 1–14.

18. Again, this assumes that the taxpayer avoids the AMT and has no additional credits or deductions. See footnote 16.

19. Sue Miller, CPA, of Frank and Company, Certified Public Accountants, McLean, Virginia, kindly offered suggestions for structuring this hypothetical example, based on client experience. However, any omissions or errors are solely those of the author.

20. On an economy-wide basis, just lifting the cap could cost 3 million small businesses $242 billion from 2005–2009, according to a recent Heritage Foundation analysis, which is consistent with the August 2004 Congressional Budget Office baseline. See Norbert J. Michel, Ph.D., and J. Scott Moody, "Raising the Social Security Cap Would Hurt Small Business," Heritage Foundation *WebMemo* No. 694, March 17, 2005, at *www.heritage.org/Research/SocialSecurity/wm694.cfm*. It is also worth mentioning that, proportionally, payroll taxes weigh most heavily on lower-income workers. This is because many low-income workers pay little or no income tax but still must pay payroll taxes.

The reasons for this are increasingly well-known. While 16 workers supported each Social Security beneficiary in 1950, lower birth rates and lengthening life expectancies have since shrunk the ratio to about three workers per beneficiary. If present trends continue, the ratio will drop to two workers per beneficiary within a generation.

Social Security's problems are drawing closer. Once they begin, they will grow quickly and exert enormous stress on the economy and on taxpayers. The system's cash flow will be inadequate to meet promised benefits by 2017 and will grow steadily worse thereafter. Just covering Social Security's cash flow problem over the next 75 years would require an additional $4 *trillion*, according to the system's trustees—$300 billion higher than the previous year's estimate.[22]

Yet even that unimaginable sum would not eliminate all of Social Security's financial needs. The Federal Reserve Board estimates that setting the system fully right would cost more than $10 trillion.[23]

Trying to address these problems through higher payroll taxes would keep the system hostage to the same demographic trends that are undermining it now: There would still be fewer and fewer workers struggling to finance benefits for more and more recipients. Workers would get smaller and smaller returns on their tax "investments" after they retired. If life expectancies increase, birthrates fall further, or immigration of younger people drops below projections, further upward revisions in payroll taxes will be needed.

Additional Tax Increases. There is another problem with depending on payroll taxes: Doing so runs a high risk of requiring higher taxes *outside of* Social Security.

Social Security has a funding surplus now. The system takes in more taxes than it needs to pay benefits, but that extra money is not being saved. It is being used to fund other functions of government. As the Social Security surplus starts shrinking after 2008, financial pressure on the overall federal budget will increase. All of the programs that were being financed with Social Security money will begin losing their access to it. The payroll tax increases now being discussed would cover the costs of *paying Social Security benefits*, but the Social Security surplus that the *rest of the government* has been using would still shrink and finally disappear. What will make up for that funding shortfall?

Furthermore, Social Security is not the only factor exerting upward pressure on the federal budget. The budget will also be squeezed notably by health care costs. Federal health care outlays for both Medicare and Medicaid are rising. Today, that spending is roughly equal to Social Security, at about 4 percent of the nation's gross domestic product (GDP). By 2050, while Social Security spending rises to 6.5 percent of GDP, Medicare and Medicaid spending will rise to 12 percent of GDP.[24] This system is unsustainable with its present financing.

Unless the rest of the federal budget can be cut back substantially (which is unlikely, based on historical experience), payroll tax increases for Social Security could well be followed or accompanied by *significant increases in other federal taxes*.

Putting Social Security on a sound financial footing will provide more flexibility for addressing the enormous challenges ahead on health care financing and the overall federal budget. But ignoring the Social Security financial crisis or taking half-measures that allow it to deepen almost guarantees that

21. See James Lockhart, Deputy Commissioner of Social Security, testimony before the Committee on Ways and Means, U.S. House of Representatives, January 26, 2004, Chart 13, at *www.ssa.gov/legislation/LockhartHearing_files/frame.htm#slide0092.htm* (May 19, 2005).

22. Social Security Administration, *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, March 23, 2005, p. 2, at *www.socialsecurity.gov/OACT/TR/TR05/tr05.pdf* (May 19, 2005).

23. See Alan Greenspan, "Future of the Social Security Program and Economics of Retirement," testimony before the Special Committee on Aging, U.S. Senate, March 15, 2005.

24. Congressional Budget Office, "Budgetary Perspectives on the Outlook for Social Security," testimony before the Committee on the Budget, U.S. House of Representatives, February 9, 2005, pp. 3–5.

these future fiscal problems will make one another worse—and lead to significant tax increases.

This leads to the key long-term issue: Even the most ambitious proposals for reforming Social Security, not to mention Medicare, still depend heavily on taxes that future workers will pay.

What if there are not enough future workers? What if all the calculations about the number of future workers are too high? This could happen if the key job-creating mechanism in the economy slows down or stops. That mechanism, of course, consists principally of entrepreneurial activities.

If the tempo of job creation by entrepreneurs slows to the point that new jobs stop appearing in large enough numbers, all of the payroll and income taxes supporting all of these programs and functions could be forced into a destructive spiral in which ever-lower revenues lead to ever-higher rates—a spiral that could start feeding on itself.

Yet that is precisely the economic risk the nation would be taking by increasing the marginal tax rate profiles of entrepreneurial activity.

Pre-Funding Social Security

There is, however, one very good reform option that can help to prevent this from happening.

A big difference between Social Security and much of the rest of federal spending is that Social Security retirement benefits can be *pre-funded*, like a typical private-sector (or government) retirement plan.[25] Doing so, particularly as part of a package of reforms, would greatly lessen Social Security's long-term squeeze on federal revenues. It would also help to create incentives for entrepreneurship by improving the retirement income prospects for entrepreneurs and those who work for them.

Pre-funding Social Security could be accomplished by diverting a portion of payroll taxes into personal retirement accounts that would be invested in broad portfolios of stocks and bonds, comparable to those used by other pension plans. Such an approach to pre-funding government retirement income programs has been implemented in recent years in Australia, Sweden, the United Kingdom, and a number of countries in Latin America and Central and Eastern Europe. In many of these nations, significant support for pre-funding has come from both business and labor. Indeed, the federal government itself offers a Thrift Savings Plan to its own employees that is based on similar principles.

However, there continues to be a hesitancy about pre-funding Social Security through personal accounts. The trouble with waiting to enact this reform is that, with each passing year, the "miracle of compound interest" has one less year to operate. Just as it is relatively inexpensive to fund a retirement starting at age 20 and very expensive to fund one at age 50, so the costs of waiting to pre-fund Social Security will grow. Each year of delay gives the investments in a personal account less time to work, resulting in smaller balances. This in turn puts greater pressure on payroll taxes to make up the difference.

Congress has a window of opportunity to put Social Security on a sounder fiscal footing by shifting toward pre-funding, perhaps setting a precedent that can help financially to sustain other entitlement programs. Or Congress can let the window close. It can continue to address the cash flow problems in Social Security and other entitlement programs through higher payroll taxes, and it can continue to ignore the effects on the larger federal budget picture and procrastinate further on the unfunded liabilities.

Taking the latter path not only would mean higher Social Security payroll taxes, but also would likely mean more pressure to increase marginal tax rates to support other government functions. It could also mean a shortfall in the jobs on which everyone is depending to keep the whole system afloat.

The Outlook for Entrepreneurial Growth

A search of the economic literature does not reveal any studies examining the impact on entre-

25. Pre-funding solutions for Medicare and Medicaid, while technically possible, have not been widely discussed. Pre-funding most other elements of government spending (other than capital spending on highways, airports, and the like) is probably impossible.

preneurship of a series of marginal rate increases of the magnitude that such a policy of drift would eventually entail, perhaps because it would be so unthinkable to most economists. However, there is some important evidence.

- A recent study of tax differences among advanced industrial countries found that during the 1990s, a tax increase of 12.8 percent led to 122 fewer hours worked per adult per year, a 4.9 percent drop in the ratio of employment to population, and a rise in off-the-books business activities in the "shadow economy" equivalent to 3.8 percent of GDP. Worse, it led to a 10 percent–30 percent loss of employment in the retail, wholesale, automotive repair, food service, and hotel industries—jobs most likely to be held by poorer workers, including minorities and immigrants.[26]
- A long-term study of Sweden showed entrepreneurial activity essentially shutting down once overall marginal rates rose well above 50 percent and estate taxes increased.[27]
- A panel study of 30 prosperous countries showed a very strong relationship between rising government shares of gross domestic product, in large part reflecting tax rates, and falling levels of self-employment.[28]
- In the U.S., another study has shown a significant drop in *hiring* by entrepreneurial businesses and the *salaries* paid to employees at such businesses as marginal rates rise.[29]

All of this meshes with anecdotal evidence from entrepreneurs. As marginal rates rise noticeably above 50 percent, the complaints of entrepreneurs seem to shift from strong skepticism ("It looks like the government would be making more on this than I would.") to outright rejection ("Why should I do it? I'd just be working for the government.").

A Social Security reform plan that is blind to these impacts could be a disaster for the nation's economic growth and the efficient use of its resources.

Entrepreneurs and Retirement

While entrepreneurs are important allocators of capital and other resources, they are also individuals with their own retirement needs. Retirement income sources in the U.S. are sometimes described as legs of a "three-legged stool," with Social Security benefits as one leg and pensions and personal savings as the other two. Entrepreneurs and those who work for them do not fare especially well with respect to any of these legs, and the prospects are not promising.

Pensions. Most people in small businesses do not have pensions. While 64 percent of full-time employees at mid-size to large-size businesses with more than 100 employees are offered employer-

26. Steven Davis and Magnus Henrekson, "Tax Effects on Work Activity, Industry Mix and Shadow Economy Size: Evidence from Rich Country Comparisons," National Bureau of Economic Research *Working Paper* No. 10509, May 2004.

27. Gunnar du Reitz and Dan Johansson, "Skatterna, foretagandet och tillvaxten" ("Taxes, Entrepreneurship, and Small Firm Growth"), *Ekonomiska Samfundets Tidskrift (Journal of the Economic Society of Finland)*, Vol. 56, No. 2 (2003), pp. 99–110. See p. 125 for a summary in English. Another study of Sweden with congruent findings is Stephan Fosler, "Do Lower Taxes Stimulate Self-Employment?" *Small Business Economics*, Vol. 19, No. 2 (September 2002), pp. 135–145, esp. Section 3.

28. Fosler, "Do Lower Taxes Stimulate Self-Employment?" esp. Section 2. A second study of marginal tax rates in 15 such well-off countries over a 15-year period found that "The results for the tax variables are remarkably consistent.… There is a great sensitivity of pretax income to effort, representing the returns from 'entrepreneurship.'… [T]he appropriate policy would appear to be to reduce the marginal tax rate." See Martin T. Robson and Colin Wren, "Marginal and Average Tax Rates and the Incentive for Self-Employment," *Southern Economic Journal*, Vol. 65, No. 4 (April 1999), pp. 757–780.

29. Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Income Taxes and the Entrepreneur's Use of Labor," *Journal of Labor Economics*, Vol. 18, No. 2 (April 2000), pp. 324–350. The authors make the interesting observation that the findings "raise the possibility that taxes on high-income entrepreneurs may be shifted in part to lower-income employees, leading to counterintuitive effects on the distribution of after-tax income." In other words, the effect of marginal rate increases may be to hurt the employment prospects and income of low-income workers the most.

supported retirement benefits, only 34 percent of full-time workers in small private establishments are covered by a retirement plan.[30] Among businesses with one to nine employees, the figure drops to 22 percent.[31]

Nor does it appear to be getting much better. Of those small businesses without pension plans, about half *have never heard of* Simplified Employer Pensions (SEP), which were intended by Congress to address this need, and only 3 percent of these companies say they are "very familiar" with SEPs. One-third have never heard of Savings Incentive Match Plan for Employees of Small Employers (SIMPLE), supposedly the other small-business pension fix, and only 11 percent express strong familiarity with it. Only 7 percent of small businesses without pension plans say that they are very likely to add them, and 43 percent say that they are very unlikely to do so.[32]

The reasons stated for this are important. Nearly three-quarters of the non-sponsoring businesses say they would be more willing to offer pensions if their companies were more profitable. Studies based on financial data from smaller companies back up this assertion, consistently showing a strong relationship between the companies' profitability and the employee benefits, like pension plans and health insurance, that they offer.[33] Taxes are obviously a major factor in determining profitability for many companies.

The next two most frequently cited reasons are also quite relevant to retirement income reform proposals: *Two-thirds of the companies without pension plans say they would be more likely to offer them if the plans did not require employer contributions, and 56 percent say they would be more likely to do so if there were business tax credits for such plans.*[34]

Savings. Most Americans, including most entrepreneurs, do not save enough money for retirement. Federal incentives like "regular" IRAs, Roth IRAs, expanded deductibility for dividend payments, and a multimillion-dollar Choose to Save education campaign mounted by a huge public–private partnership are not working. Only 18 percent of the American people have more than $100,000 in private savings dedicated to their retirement, and only 38 percent have more than $25,000.[35] While some of those with higher savings may be younger workers who will continue adding to their savings, these amounts still represent very little money for periods of retirement that are likely to span 10–15 years.

Figures on personal savings for retirement are not generally available by business size, but a study by the National Association for the Self-Employed found that 78 percent of the entrepreneurs that it represents had saved less than $100,000 for retirement, although virtually none of them had private-sector pensions and their median age was 46.[36] When questioned closely in a major national poll on saving, a majority of those not saving enough (in other words, a majority of a majority) said that they do not save because they simply do not have surplus cash to allocate to savings. This is particularly

30. Employee Benefit Research Institute and American Savings Education Council, *The 2003 Small Employer Retirement Survey* (Washington, D.C.: Employee Benefit Research Institute, 2003), p. 1.
31. Employee Benefit Research Institute, *EBRI Notes*, Vol. 22, No. 1 (January 2001). Data compiled from U.S. Department of Commerce, Bureau of the Census, *Current Population Surveys*, March 1995–March 2000. The figures are for 1999.
32. Employee Benefit Research Institute and American Savings Education Council, *The 2003 Small Employer Retirement Survey*, p. 3.
33. William J. Dennis, Jr., "Wages, Health Insurance and Pension Plans: The Relationship Between Employee Compensation and Small Business Owner Income," *Small Business Economics*, Vol. 15, No. 2 (June 2000), pp. 247–263.
34. *Ibid*., p. 2.
35. Ruth Helman and Variny Paladino, "Will Americans Ever Become Savers?" Employee Benefit Research Institute *Issue Brief* No. 268, April 2004, p. 5.
36. National Association for the Self-Employed, "Social Security and the Self-Employed," testimony before National Commission on Retirement Policy, Center for Strategic and International Studies, May 1997.

true of people at middle-income to lower-income levels.[37]

Social Security Benefits. Since entrepreneurs and those whom they hire are less likely than employees of larger companies to have pensions and no more likely to have adequate retirement savings, they would be more seriously and disproportionately affected by cuts in Social Security *benefits*. Equally disturbing, such benefit cuts would make retirement planning an even more daunting challenge for entrepreneurs and small business. In the words of David Birch, a pioneer in modern studies of job creation:

> The average graduate from high school or college will have 13 different jobs during their working life. They will average 3½ years on each job. Clearly they are going to have to build a retirement plan themselves, since it takes at least three years to get vested under retirement law.… The majority of people in college or high school are very much into free agency.… They view themselves as providing for their own retirement.… They do whatever it takes, but they are going to have to build their retirement fund.[38]

If retirement income prospects were to discourage many in this cohort from taking up entrepreneurship in favor of "safer" choices like long-term employment in large enterprises (even if that were a realistic option), the consequences for the nation's economic efficiency, openness, growth, and innovation would be damaging. Again, any major slowdowns in the nation's engine of job creation, which is largely powered by entrepreneurs, would have enormously negative consequences for Social Security.

Principles for Reform

Taken together, these findings suggest five important principles for retirement policy and Social Security reform:

1. Efforts to *expand pension coverage* are unlikely to succeed unless the coverage is significantly tax-advantaged and easily administered, employer contributions are minimized, and the overall economic climate is positive.
2. Simply providing *new opportunities to save* will not solve the retirement income dilemma. Individuals already have many attractive ways to save for retirement, but these opportunities are underutilized by many middle-income and lower-income citizens, who say that they do not have enough money left to save for retirement after they pay for their basic needs.
3. *Social Security benefits* are likely to be a more important source of retirement income for entrepreneurs and those who work in smaller companies than for other Americans.
4. Some way must be found to *sustain and, if possible, increase retirement benefits*—one that does not increase payroll taxes and that does not assume that voluntary contributions will be made to a savings plan simply because that plan exists.
5. *Raising taxes on entrepreneurs* is not the way out of the dilemma. If Congress tries to "solve" Social Security's financial problems by raising marginal tax rates, there will be fewer entrepreneurs. If there are fewer entrepreneurs, there will be fewer new jobs created and slower economic growth. With fewer jobs and slower growth, Social Security's problems will become far worse.

The Best Reform Option for Entrepreneurs

Of all the Social Security reform proposals currently being discussed, the one that best fits all of these criteria is diverting a portion of existing payroll taxes into personal accounts that workers

37. For example, see Employee Benefit Research Institute, American Savings Education Council, and Matthew Greenwald & Associates, Inc., Retirement Confidence Surveys, 1996–2004. In the 2004 survey, 60 percent of those who were not willing to save more and 55 percent of those who were willing cited "can't afford cut back/spend less" or "have other priorities now" as the reasons they were not currently doing so. Another quarter of each group said that they were already saving enough, a statement that was empirically untrue for most of them. (See Figure 12 in the 2004 survey).

38. David Birch, interview with *The Wall Street Journal*, May 24, 1999, p. R30.

would own and control themselves. There are several key reasons for this.

- Personal accounts that are developed from existing payroll taxes would likely increase Social Security benefits while avoiding major payroll tax increases. This meets two of the entrepreneur's needs simultaneously. It could decisively improve the rate of return that entrepreneurs would achieve for their own retirements, and it could help to avoid marginal tax increases that would create an unfavorable economic climate for entrepreneurial activities. Both factors would create strong incentives for entrepreneurship.
- The personal account option would *not* require the entrepreneur, as an employer, to increase the contribution level for employee pensions or savings funds. Yet personal accounts would likely offer those employees a better rate of return than they could expect from the existing Social Security system. This would make *working for* an entrepreneurial business—even one without a pension plan (or one with a plan that requires several years to vest)—a more attractive option for potential employees.
- The personal account option directly addresses the two key structural flaws in the current system: the demographic squeeze of fewer workers supporting more retirees for longer periods of time and the huge unfunded liability. Payroll tax increases would not fundamentally address either structural problem. Under a personal account system, benefits would rise as the value of investments rose. The benefits would not depend on the forbearance of workers under ever-heavier tax burdens or on some unlikely spurt of population growth. What are often called the "transition costs" to a personal account system are seen more accurately as an explicit recognition of existing liabilities in a system that is paying down those liabilities and pre-funding its future pension benefits like most pension plans. Moving toward pre-funding and paying down unfunded liabilities are important steps in reducing the downstream pressure for higher taxes.
- Since personal accounts would create assets that could be passed on to heirs, the number of individuals receiving inheritances (or larger inheritances) would rise. This would aid the retirement income prospects of the *next* generation. Research has also shown that individuals receiving inheritances are far more likely to engage in entrepreneurial activities than is the population as a whole.[39] Thus, personal accounts, in and of themselves, would indirectly increase entrepreneurship.
- Because entrepreneurs focus on economic risks, they are likely to make informed choices about whether or not to choose personal accounts and to convey their thinking to their employees. This kind of constructive scrutiny will be good for the system. However, entrepreneurs will also understand, and be accepting of the fact, that some people may choose the "known" of the traditional Social Security system over the relative "unknowns" of personal accounts.
- A personal account system would help to curtail the current practice of having the Treasury Department cover its borrowing from the Social Security system by issuing non–publicly traded government securities (IOUs) to that system. In contrast to this practice, personal account funds would be invested in private and public equities markets, where money is substantially more transparent and fungible. Over time, therefore, personal accounts would likely increase the capital available for entrepreneurial ventures.

In sum, personal accounts offer two fundamental advantages for small business: actions that the government would *not have to take* (unnecessarily raising taxes or cutting Social Security benefits) and results that the private sector *would* generate (enhanced entrepreneurship, strengthened capital markets, and improved retirement incomes). In the end, empowering entrepreneurs in this way would

39. Douglas Holtz-Eakin, David Joulfain, and Harvey S. Rosen, "Entrepreneurial Decisions and Liquidity Constraints," *RAND Journal of Economics*, Vol. 25, No. 2 (Summer 1994), pp. 334–347.

benefit the entire nation as additional jobs were created and economic growth was sustained.

As for the Social Security system itself, perhaps no one has offered a better appraisal than its founder, President Franklin D. Roosevelt:

> Social Security is a development towards [a] goal, rather than a finished product. We should be constantly seeking to perfect and strengthen it in the light of our accumulating experience and growing appreciation of social needs.[40]

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40. Quoted in John Breaux, "Rising to the Challenge," *The New Democrat*, Vol. 10, No. 6 (November 1998), p. 29.