How Public Policies Undermine the Rules for *Getting Rich in America*

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Contemporary Issues Series 93

February 1999

CSAB

Center for the
Study of
American Business

Washington University in St. Louis

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Many government policies make it difficult for Americans to build the wealth necessary for a comfortable retirement. Of course, financing government unavoidably reduces the money citizens have to prepare for their financial futures. The best we can hope for is that government policies minimize this cost. Unfortunately, despite the politically expressed desire for people to get better educations, work harder, earn more and increase their savings, politicians seldom consider the negative effect of their policies on the ability and motivation of people to accumulate wealth.

We have been thinking about the public policy obstacles to pursuing sensible financial goals since we published *Getting Rich in America: A Few Easy Rules to Follow* last January as a Center for the Study of American Business publication.[1] In response to the interest in that publication, we have expanded the discussion into a book titled *Getting Rich in America: 8 Simple Rules for Building a Fortune and a Satisfying Life*. The theme of the pamphlet and book is that the overwhelming majority of Americans can get "rich" (accumulate a net worth of at least $1 million in today's dollar) by retirement—if they work hard, study diligently, resist frivolous temptations, get

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married and stay married, take care of themselves, invest wisely by taking prudent risks, and above all, be patient. [See page 32 for a synopsis of these rules.]

Though getting rich requires some sacrifice and effort, it is not as difficult as most people believe. Our rules are a way of taking responsibility for one's life and achieving a level of personal satisfaction that can be more valuable than the financial wealth realized. So why haven't more people taken advantage of the opportunity to get on and stay on the path to a life full of meaning and affluence? There are a number of reasons, which we shall discuss. But surely an important reason is public policies that discourage the hard work, saving, investment, stable marriage, and patience that are the foundation of a life of responsibility and wealth accumulation.

It is important to recognize that public policy makes it more difficult for Americans to follow our rules.

Of course, our point has never been that all Americans *will* get rich. A few will be unable to follow our rules, mainly because of misfortunes they confront. A far greater number will simply not take our rules seriously. Many Americans will continue to think that they have no choice, that others owe them a living now and in their retirement years, that they do not have to take responsibility for their futures (given the inheritance that they expect). They will continue to believe that they can scrape by or get lucky even if they refuse to work and study hard and long, squander their incomes, marry and divorce at will, invest poorly, and impatiently pursue get-rich-quick schemes. These Americans will never take advantage of the enormous opportunities their country offers. They will be the first, however, to envy those who do take advantage of them by playing by the rules we have outlined.

Devising Public Policies That Foster Allegiance to the Rules

While we emphasize the importance of the choices that individuals make in determining how well they do, it is important to recognize that public policy makes it more difficult for Americans to follow our rules. The basic problem is that private efforts to do well in this country require a long-term perspective, one covering several decades, because that is the time it takes for our rules to begin paying off. However, public policies are devised by politicians with short-term political horizons that seldom extend beyond the next election. They prefer to devise policies that suggest immediate progress rather than policies that provide gradual, but real, progress over several decades.

Unfortunately, short-run policies undermine the resolve of many Americans to take the long view. Many voters reason that if they don't take the short-term benefits offered by public policies now, they will lose out to those who do. This can be especially true for voters who worry that some new collection of unbridled future politicians will sabotage the economy with ill-advised policies that will take much of the wealth that following the rules allow them to create.

Our central message is that Americans need to live within a few basic rules. There is a corollary message: The politicians—or rule makers—must also live within some rules of their own. Put another way, the problems Americans have in living by sensible rules are compounded if their politicians don't do the same. How have public policies discouraged Americans from following the basic rules we have outlined? Let us count the many ways.

Rules for the Rule Makers

We have already indicated one important way public policies can discourage Americans from living by the rules and building wealth: by maintaining the threat to take away wealth in the future, either before death with taxes applied to financial and real assets, or after death through inheritance taxes.

When governments take wealth, before or after death, they obviously reduce the benefits of creating wealth. An increase in the rates of wealth taxes today can cause people to fear even higher tax rates in the future. Such threats encourage profligate behavior by well-meaning citizens. What is spent on consumables today, from trips to hairdressers to ocean cruises to movies to ice cream cones, cannot be taxed in the future.

When politicians allow threats of greater taxation in the future to persist, they also impair our incentives to acquire more skills, to work harder and longer, to save and invest wisely, and to be patient. Indeed, such policies encourage impatience, a shortening of people's time horizons, and greater consumption today, the exact opposite of what the government needs to encourage. Even inheritance taxes, collected after people are dead, can encourage current consumption and less saving simply because they lower the gains savers can expect for themselves and their heirs (or for the beneficiaries of charitable foundations that can be established with estates).

The Founding Fathers understood the need for constitutional constraints on the size and scope of government and enacted constraints precisely because they wanted this country to grow into a wealthy country, which it did. The Founding Fathers believed in rules for those who govern just as surely as they believed in rules for the governed.

When governments take wealth, before or after death, they obviously reduce benefits of creating wealth.

Unfortunately, as wealth grows it becomes tempting for politicians to tap into that wealth to fund an endless number of public projects and programs. In the process, they resurrect the threat of greater wealth taking in the future, which impairs productive incentives and undermines the future wealth of the country and its citizens.

Income Tax Threats

Public policy can discourage Americans from following our rules with a variety of other taxes, not the least of which is income taxation. Income taxes reduce the payoff from hard work and studying—and the higher the income tax rates, the greater the reduction. Obviously, a higher tax rate means that there is less to spend, but less obviously, the higher tax rate means a significant reduction in a person's potential net worth at retirement time.

If the income tax rate is 25 percent and the person works harder and longer and earns an additional $1,000 a year for purposes of saving, he or she will end up with

$750 to actually save and invest. If the tax rate is 45 percent, then the person is left with $550, or 27 percent less in after-tax income to invest than when the tax rate is 25 percent. This $200 difference in annual tax payments might not sound like much, but when the return on it is compounded from age 18 to 67, the sum becomes a nontrivial loss in net worth of slightly more than $106,000 at age 67 (when the rate of appreciation is 8 percent).

In the 1950s and early 1960s, the highest federal marginal tax rate, paid only by the rich in the country, was an unbelievable 90 percent, which means that those in that tax bracket got to keep only a dime of any extra dollar in income that they earned.[2] The highest marginal tax rate was first lowered to 70 percent under the Johnson administration. During the Reagan administration, the highest marginal tax rate was lowered all the way to 28 percent, and the most productive Americans went from keeping only a dime of each extra dollar of income in the early 1960s to keeping 73 cents of each extra taxable dollar in 1989.[3] We applauded this tax reduction not so much because we favor the rich of the country, but because of the positive effects the falling tax rates had on ordinary Americans' incentives to work, save, invest—and follow all of the other rules for wealth accumulation that we have discussed. Unfortunately, since 1990, the highest federal marginal tax rate has risen. It is now back up to nearly 40 percent, and the most productive are, as a consequence, paying a larger share of their incomes in federal income (and other) taxes.[4]

We understand that many believe that those with higher incomes should pay higher tax rates, especially if it means lower taxes for lower-income Americans. But one should realize that higher tax rates on the rich leave lower-income Americans unscathed only when they do not anticipate a substantial improvement in their incomes. In fact, many low-income Americans will become high-income Americans, because they will follow the rules for getting rich. Americans who anticipate an improvement in their incomes must anticipate paying the higher tax rates, which means that current high tax rates on the rich can discourage the well-meaning efforts of low-income Americans as much, or more, as high-income Americans. We are concerned here with those Americans who have not yet realized their fondest dreams. We do not want them to be unnecessarily discouraged by a shortsighted tax code.

We applauded this tax reduction ... because of the positive effects the falling tax rates had on ordinary Americans' incentives to work, save, invest.

The high tax rates on today's rich might indeed lead to more current revenues for government, but less tax revenue in the future because of what Americans of all income levels *don't* do over the next few years in response to today's high tax rates. Government is not exempt from the realities that apply to its citizens. The more it burdens the economy to spend today, the less it will have to spend in the future.

Our arguments lead to the conclusion that to avoid discouraging Americans from living by the rules, tax rates should be as low as possible. There must be rules—restrictions—on how much politicians can take in taxes to cater to special-interest groups that see government as a means for capturing short-run advantages at the long-run expense of the general public.

Public Welfare

Public welfare is one of those government programs people love to hate, and with good reason. The debate over whether or not we should have welfare is not one we wish to broach. Welfare in some form is with us to stay, mainly because we are a wealthy country and can afford the attempt to help those with little. In countries where almost everyone lives at or close to the subsistence level, there is no economic foundation for welfare simply because there are so few "haves" from whom income and wealth can be taken to be given to the "have nots." It was only after our market economy had eliminated most poverty that the government got into the business of trying to reduce it with public transfers.

Yet we appreciate why efforts at broad welfare reform have recently begun to achieve political momentum at both the state and federal levels. People have begun to understand that welfare has undercut the incentives of many low-income Americans to live by the rules we have developed. It has provided people with a bounty, albeit a modest one, not to work or to stay out of work longer than they might otherwise. We have noted the disincentive effects of high marginal tax rates for modest and high-income people. But, the poor on welfare have, in effect, faced marginal tax rates that are much higher than those faced by higher-income Americans.

How can this be? Well, even many low-income people face the Social Security tax as well as state and federal income taxes. They also understand that when they earn more income, they give up an array of welfare benefits, from food stamps and free school lunches to rent subsidies and medical benefits. When all of the things that must be given up are added together, the total money value for many welfare recipients can easily exceed their additional income, which means they can face an effective income tax rate of more than 100 percent, which would discourage anyone from working. One motivation to reform welfare has been to cut out waste and abuse in the system, but another reason is to lower the effective tax rates faced by poor Americans. Cut the total benefits, and you don't have to cut the recipients' benefits as much with any additional income they earn; hence, you lower their effective tax rates. Lower their effective tax rate and you give welfare recipients more incentive to work and build productive lives.

People have begun to understand that welfare has undercut the incentives of many low-income Americans to live by the rules we have developed.

Welfare reform has also been motivated by the drive to ensure that the welfare system doesn't discourage marriage and does encourage married couples to stay together longer. All too often, welfare has discouraged marriage and encouraged young women to have illegitimate children and receive welfare checks that were more reliable than the support of available marriage prospects. It has also encouraged marital breakups as spouses noticed that they could get more benefits if they divorced.[5]

Welfare has also discouraged welfare

recipients from accumulating wealth because of wealth restrictions on eligibility on benefits. These are well-intended restrictions. However, they encourage welfare recipients to spend everything they get—and not to be patient and plan for the future. Consider the 1992 case of Sandra Rosada who wanted to go to college and become a teacher rather than become a welfare recipient like her mother. So the Connecticut teenager got a part-time job and diligently saved her money, accumulating almost $5,000. Unfortunately, when Connecticut welfare officials found out about Sandra's saving they informed her mother that the money had to be spent immediately if the family was to remain eligible for welfare. Furthermore, federal authorities ordered Sandra's mother to repay $9,342 of the benefits she received during the time her daughter's money was in the bank.[6] Sandra and her mother learned an important lesson: when on welfare, don't live by the rules that can allow one to accumulate wealth and escape dependence.

Obviously, one of the first rules the rule makers should adopt is "do no harm." Too many public policies do outright harm, something that neither political liberals nor conservatives should want.

The Marriage Penalty

Unfortunately, the federal tax code discriminates against many married couples. How's that? A wife and husband, both of whom work, often pay more in taxes than they would have to pay if they were single living apart or even if they were just living together. The problem stems primarily from our progressive income tax-rate schedule, which requires everyone to pay at a higher (marginal) tax rate on added income.

For example, if a single woman and a single man each earned a taxable income of $45,000 a year, the first $25,350 would be taxed at a tax rate of 15 percent, with the remaining income taxed at a 28 percent rate, which means that each would pay $9,305 in federal taxes. If they lived together unmarried their combined taxes would be $18,610, for an average tax rate of less than 21 percent on their combined income of $90,000. If they got married, however, they would pay a total of $21,905 in taxes for an average tax rate of slightly more than 24 percent on their combined income. The couple would pay, in other words, a "marriage penalty" of $3,295, mainly because all of the income of the second working spouse would be taxed at 28 percent (not part at 15 percent and the rest at 28 percent as in the case of the single taxpayers).

The federal tax code discriminates against many married couples.

Of course, not all couples will change their marriage plans by the added tax burden, but we should expect *some* couples to be affected, because there are some couples whose marriage decisions are on the margin; that is to say, the couples are debating whether to marry and, if married, whether to divorce, and the decision is close. The penalty we noted above can be just large enough to cause some single couples to decide not to marry and some married couples to divorce. It can cause other married couples to worry more about a future divorce. The point is that the marriage penalty can undercut many

Americans' incentives to do those things that keep a marriage together and that, at the same time, help build their net worth.

Clearly, the rule makers should consider reducing, if not eliminating, the marriage tax. One easy reform is to allow married couples to compute their income taxes in two ways—as two separate filers and as joint filers—and let them pay the smaller amount.

The Flatter Tax

When it comes to policy debates over the appropriate tax system, we favor what has been dubbed the "flat (or flatter) tax rate" system, under which everyone is charged the exact same rate. One compelling argument for such a system—which includes a much cleaner (less complicated definition of the) tax base—is that it is far simpler than the grossly convoluted progressive tax-rate system we now have (which is so complicated that not even tax experts can agree on how much taxpayers owe). We also support the flat-tax system because it amounts to a rule imposed on politicians that says, in effect, you can't raise the taxes on anyone without raising the taxes on everyone. Under the current tax system, the tax rates on higher-income people can be raised without the tax rates being raised on lower-income people. We don't think this is fair, but more importantly, the ability of government to raise the taxes on higher-income people discourages people from living by the rules we have laid out.

Contrary to what is widely believed, most high-income earners are where they are on the income ladder because they have made sacrifices others have not. We not only want all Americans to enjoy the fruits of their labor, we want to encourage virtuous—rule-based—behavior.

The flat-tax proposal has always been rooted in a simple proposition: that lower tax rates stimulate work, saving, and investment, all of which are required for growth in jobs and incomes. Indeed, lowering unnecessarily "high," marginal tax rates can result in more tax revenue from high-income earners. Cuts in marginal tax rates may result in lower tax revenues temporarily, given that income levels can't be changed overnight. However, because the lower tax rates stimulate income growth, they can soon lead to higher revenues.[7]

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Problems with Inflation

Governments do not have to pass higher tax rates on wealth or income to dampen people's incentives to live by the rules. All they have to do is unexpectedly run up the rates of inflation or deficit spending. An unexpected increase in the inflation rate can catch many wealth accumulators with their economic pants down, given that the real value of their wealth will immediately fall with any unexpected hike in the price level. If prices begin to rise unexpectedly, people will *eventually* take note of the higher inflation rate and demand higher interest rates to compensate for the deteriorating value of their wealth holdings, but that still means that when the higher inflation rate catches them off-guard, their wealth will be eroded. If prices rise by 50 percent more than expected over, say, five years, people's wealth will be eroded by a third.

With escalating inflation rates, which the country experienced in the 1960s, 1970s, and into the early 1980s, the temptation is strong to spend more, save less, and if already in debt, go deeper in debt. They can reason that the burden of their debt will be reduced with inflation. So instead of living by the rules of saving and investing, they will live by a new set of rules, taking whatever credit is available.

Moreover, the higher inflation rate drives up people's incomes (measured in dollars), and even though they are not earning more in purchasing-power terms, they end up paying higher tax rates, given the progressive tax rate system. Also, inflation has historically been associated with poorer stock market performance, and much lower returns on fixed-income investments such as bonds and savings accounts. For all of these reasons inflation can thwart Americans' incentives to work, stay in school, save and invest—and be patient.

Granted, the American economy has, since the early 1980s, been enjoying a declining rate of inflation, with the annual inflation rate at this writing between 1 and 2 percent. However, the mere threat of a return of the upward inflationary spiral of the 1960s and 1970s can cause many Americans to fret, "There is no use obeying the rules if my wealth is taken from me through future inflation."

Similarly, past government budget deficits have, no doubt, caused some people to worry that their accumulated wealth and incomes will be eroded in the future by higher taxes that are imposed to pay off the accumulated government debt, or by higher inflation rates that are allowed to escalate because they effectively cut the real burden of the government debt.

Politicians must be asked to abide by fiscal rules that keep inflation and deficits under control. Such rules can make it easier for Americans to live by the rules that will increase their wealth and the nation's wealth.

The Problem of Social Security

No government program has done more to discourage Americans from following the rules of wealth accumulation than Social Security. Social Security is widely viewed as a system under which Americans pay into some government-backed investment fund during their working years from which they draw their pro rata share of benefits during their retirement years. Nothing could be further from the truth. Social Security is best described as a welfare system for the retired elderly financed by those still working. The workers (many of whom are poor) pay Social Security taxes based on their income, and the revenues collected are used to cover checks sent to the retired elderly (many of whom are rich). The amounts of the retirees' checks are determined by politics, not by the economics of what the recipients paid into the system during their working years. Not surprisingly, Social Security is a financial "train wreck" in progress.

The Social Security system was established in 1935 as a means of providing Americans with some guaranteed retirement income. With the stock market crash in 1929 and the Great Depression of the 1930s, many Americans lost faith in their ability to plan for their own retirement income. At least, that was the political rationale for Social Security. Moreover, the system was set up to be a great deal for the initial retirees, who would in the 1930s and 1940s pay into the system at very low tax rates for very short periods of time and be able to draw out far more than they paid in. For decades, when there were far more American workers paying into the system than there were retired beneficiaries, the retirees got several times more (five and ten times more) in benefits than they paid in taxes, and more than what they could have gotten had their taxes been put in a savings account.

No government program has done more to discourage Americans from following the rules of wealth accumulation than Social Security.

The very first Social Security beneficiary, Ida Fuller, a legal secretary, had paid only $45 into the system when she retired in 1940. However, before she died at 100 in 1975, she had collected more than $20,000 in Social Security checks, nearly 450 times her Social Security taxes. She got an extraordinarily good deal, one that is rarely duplicated through market investments. Her good fortune was the product of her longevity, but it was also possible because there were 45 workers for every retiree in the early 1940s, which meant that Social Security tax rates on each worker could be modest.[8] The system could be generous to other retirees because life expectancy in the 1930s was less than the Social Security retirement age of 65. The average male could then expect to receive checks for only about three and a half years. The average female could expect to receive checks for only a few years longer.

Obviously, the government was counting on many Americans dying before they could draw benefits.

Now, however, the country faces a dramatically different situation with the "graying of America" (the aging of the baby boom generation). American workers can be expected to pay into the system at high rates of taxation (currently 12.4 percent of income, when the employee's and employer's shares are combined), on a high-income tax base (currently up to $68,400), for a long and lengthening period of time (with the age at which full benefits can be received scheduled to rise in one-month steps from age 65 to age 67 by 2022). If current trends continue, today's college-age generation can expect to be paying 53 percent of their income in Social Security and Medicare taxes just before they retire, and Social Security and Medicare outlays will consume all federal revenues by 2040.[9] Of course, such calamitous trends are unlikely to continue because adjustments will have to be made in the system.

The problems in the system are clearly a product of the declining ratio of worker-taxpayers to elderly beneficiaries and the increasing longevity of Americans. In 1951, there were 16 workers to every Social Security beneficiary. In 1975, the ratio was down to just over 3 workers per beneficiary. By the middle of the 21st century, the ratio will be no higher than two workers for every beneficiary. Today, the life expectancy for all Americans is over 76 years and rising.

Retirees from the post baby-boom generation, who will begin retiring in 2032, will be lucky if they get back in benefits what they paid in taxes, and they can forget about the interest that they may feel they deserve. Still, because of the rapidly growing number of elderly retirees, the system is clearly headed for bankruptcy, and reforms will likely lead to some combination of higher tax rates on workers and reductions in benefits for retirees in the years ahead.[10]

Even without further curbs in benefits, the Social Security system will not be a bargain for Americans who, as shown in Table 1, were born in 1955. That table shows the expected compounded rates of return on the Social Security taxes paid (under current laws) for taxpayers with three different income levels. Note that the highest rate of return is for very low-wage couples, whom the system was particularly designed to help. But their rate of return is only 3.11 percent, almost a full five percentage points below the real rate of return on the S&P 500 that we have been using. The poor single guy can expect a rate of return of only 2.45 percent. The high-income couple can expect much less, 1.40 percent, while the high-income single guy can expect a scant 0.08 percent. (That is not 8 percent, but *eight one-hundredths of a percentage point*!)

The research firm of Ibbotson Associates has figured that a couple earning $26,000 a year while they are working will over the course of their careers pay into the Social Security system about $320,000 in Social Security taxes (when their employers' share of the taxes are added). They can expect to receive about $450,000 in real retirement benefits before they die, resulting in a real rate of return of just 1.23 percent. However, if the taxes had been invested in an mutual index fund, the couple could have had at retirement an additional net worth of $975,000 (assuming a rate of increase of 7.56 percent), from which they could draw an annual retirement income of over $68,000 without touching their principal (at an interest rate of 7 percent), more than twice what they

Table 1.
Social Security: A Bad Deal for Americans Born in 1955

Annual Salary	Annual Rates of Return		
	Single Men	Single Women	Married Couples, Both Working
Minimum ($10,700)	2.45%	2.94%	3.11%
Average ($28,000)	1.43%	1.98%	2.06%
Maximum ($68,400 and higher)	0.08%	0.73%	1.40%

Source: Social Security Administration, as reported in Richard W. Stevenson, "To Social Security Critics, the Argument is Simple," *New York Times*, March 2, 1997, p. A1.

could expect *at maximum* in annual Social Security payments.[11]

An interesting, though disheartening, fact is that blacks, especially black males, can be expected to do much worse than average.[12] The reason? Black males still have a life expectancy of less than 65 years, eight and a half years shorter than their white counterparts.

What is sad about the prospects for Social Security benefits is that many well-meaning Americans have also been sucked into believing that they did not need to save as much as otherwise because of Social Security promises. So the Social Security system has reduced aggregate savings in the country by trillions of dollars over its 65-year history, leaving not just individuals worse off, but the entire economy less productive than it would have otherwise been.[13] It has been estimated that over the 30-year period of 1960-89 the cumulative loss because of Social Security came to about 3 percent of the gross domestic product, or about $182 billion in 1992 dollars.[14] The same study also found that

Social Security also reduced the marriage rate and increased the divorce rate, over the period of 1960-89. This is consistent with the fact that Social Security shifts one's marginal reliance for support during old age away from family and toward government.[15]

It's been tempting for presidents to make saving Social Security the administration's highest legislative goal, as did President Bill Clinton in 1998. He and other presidential candidates have not realized that long before the system becomes insolvent during the next century, Social Security will have lost its *raison d'être*. Continuing developments in the nation's financial markets will gradually make Social Security an obsolete system for retirement planning, not to mention the unbelievably bad deal that Table 1 reveals it to be.

In calling for reforms, critics of Social Security point to the threat the aging baby boomers pose for the system's financial solvency. Indeed, the system's payments to the elderly will exceed its tax revenues by 2019. In their search for a rescue, reformers mistakenly presume that Social Security will be as needed in the future as it was sixty years ago when it was conceived. Nothing could be further from the truth.

Policymakers will eventually wake up to the simple fact that for the overwhelming majority of Americans, Social Security is not only bad personal economics, it is unnecessary and harmful public policy. The privatization of retirement planning is inevitable. It will happen, gradually but persistently.

One of the more appealing arguments for Social Security has always been that the system provides a form of "social insurance." Through Social Security, and the federal government's taxing authority, the retirement income of *each and every* American depends, to an important degree, on the earnings of *all* Americans. The earnings of all Americans are far more stable and predictable than the earnings of any one individual, which implies a reduction in the risks of building a retirement income.

Social Security is not only bad personal economics, it is unnecessary and harmful public policy.

However, as social insurance, the system is rapidly losing its justification. Americans now have far superior means of planning for their retirements than their grandparents did. They have substantially more income to save, which means they can develop more diversified—hence less risky—financial portfolios from which they can draw retirement incomes. Americans' investment options now include more than 8,000 mutual funds, each of which can own hundreds of securities. And Americans can, in effect, buy an interest in the entire market through index funds, including those funds that buy the shares of all 500 companies in the Standard & Poor's Composite Index.

Policymakers must now recognize that these investment alternatives offer Americans the opportunity to buy their own form of social insurance. That is, Americans can tie their retirement incomes to developments in the national economy, giving them practically the same diversification for retirement security that Social Security achieves by lumping all workers together in one massive program.

Privately devised social insurance for

retirement income has four obvious advantages:

- Private social insurance will provide a far higher rate of return than Social Security's intergenerational transfer approach could ever hope to offer. The real annual rate of return on market investments will likely continue at the pace of the past fifty years, about 8 percent a year, leading to a doubling of the real value of Americans' portfolios every nine years or less.
- Through private social insurance, individual Americans can tailor their investments to fit their own financial goals. They will not have to accept the one-size-fits-all retirement philosophy built into the Social Security system.
- Americans can determine their own rate of draw from their retirement funds, choosing to leave their financial assets to their children, if they wish. Under Social Security there is nothing to leave.
- Private social insurance would increase savings that are available for investment, the result being more capital accumulation and therefore greater productivity and higher wages than otherwise.

Lawmakers will eventually give up the pretence that they can plan for their constituents' retirements better than their constituents can. Clearly, many disadvantaged Americans will need help with their retirements. Just as clearly, for most Americans Social Security is not only a bad deal but also an anachronism. No wonder countries such as Britain, Australia, and Chile have begun to replace their own elderly benefit systems with simple mandates that their citizens set aside so much of their earnings in private investment accounts over which the citizens, not politicians, have control.

Regulatory Obstacles to Fortune Building

Many Americans cannot live by the rules promoting wealth accumulation because of regulations that may have been well-intended but have unfortunate, perverse consequences. A particularly insidious example is the minimum wage. Every three years or so, proponents and opponents of minimum wages laws lock horns over a proposed increase in the wage rate paid to millions of the nation's lowest-income workers. As we developed this project, the Clinton administration had once again proposed raising the minimum wage, this time by $1 an hour over two years, from $5.15 an hour over two years to $6.15. According to minimum wage supporters, a hike in the mandated wage will make millions of workers better off.

Opponents concede that many workers might gain from the mandated wage hike but argue that a hundred thousand or so jobs will be destroyed by the proposed hike in the cost of unskilled labor. Because of the minimum wage, many employers will be unable to afford as many workers. Other employers will be forced to automate many entry-level jobs out of existence.

Regrettably, both sides continue to misframe the issue. When properly framed, it is clear that the workers who retain their low-paying jobs will likely be worse off as a consequence, but relatively few job losses should also be expected.

Still, the job losses—even if substantially less than a hundred thousand—cannot and should not be ignored. Those job losses will mean that some of America's lowest-paid workers will be unable to play by our rules for making it in this country. They simply won't have jobs at which they can work long and hard. They won't get that all-important, initial on-the-job training that many need desperately (and some of the more important on-the-job training comes in the form of being told such basic things as the importance of showing up on time). They won't be able to start on the road to prosperity as soon as they should. They will have to sit on the sidelines and wait until hopefully their additional maturity increases their dependability enough to make them employable in a minimum-wage job.

But even many of those workers who get the minimum-wage jobs will be worse off with the higher wage. To understand why, consider that when the minimum wage is raised, employers can be expected to cut forms of payment not covered by the federal mandate—namely, fringe benefits and workplace amenities—and, at the same time, increase work demands. If employers could have paid "low" wages without the minimum wage, then they will be able to pay "lower benefits" with it. They also would have to lower benefits and/or increase work demands, or else suffer the competitive consequences of higher labor costs when other employers cut benefits and/or increase work demands.

More important for our purposes, a hike in the minimum wage can reduce the inclination of employers to provide on-the-job training. With more workers at employers' doors than they are willing to hire, because of the wage hike, training is a fringe benefit that will suffer. The lost on-the-job training can impair the incentive for workers, especially young ones, to increase their skills and future earning potential.

A series of econometric studies over the past fifteen years has shown that minimum-wage hikes do have the predicted effects: work demands are increased; on-the-job training is reduced; days for vacation and sick leave are cut; year-end bonuses, severance pay, and shift premiums are slashed. In general, working conditions worsen. So not as many jobs are lost as many believe simply because the *net* increase in labor costs is far lower than the increase in the minimum wage.[16]

But should we expect the covered workers to be better off *on balance*? The answer is "not for long." Since the benefits provided in the past were worth more to workers than the workers had to suffer in wage costs, the deletion of the benefits should mean workers are worse off because of the minimum wage hike. North Carolina State University economist Walter Wessels, a minimum-wage researcher, estimates that covered workers are indeed made worse off, on balance, each time the minimum wage is raised. A hike in the minimum wage basically undercuts the value of jobs to workers.[17]

Even many of those workers who get the minimum-wage jobs will be worse off with the higher wage.

If a hike in the minimum wage caused an increase in the overall value of unskilled jobs, as both critics and proponents seem to agree happens, then the rate at which covered workers voluntarily quit their jobs should fall. But the "quit rate" goes up, and the reason is that the jobs aren't, on balance, worth as much to the covered workers.

The net effect of the higher wages, lower benefits, and greater work demands is that future researchers will find that employment will have decreased slightly. The small drop in jobs is partly due to the fact that the jobs are not worth quite as much for workers to take and slightly less profitable for employers to provide.

The moral of the minimum-wage story is really quite simple: the problem of elevating the welfare of the country's lowest-paid workers is far more complex than minimum-wage proponents would have us believe. A minimum-wage hike does not, and cannot, translate into a long-term improvement in the welfare of workers. The small number of job losses resulting from past minimum-wage increases is not an argument for another round of wage mandates. Rather, it testifies to the fact that politicians do not have the market clout they think they have. The low count of job losses is also testimonial to the extent to which market adjustments have minimized the damage done by our political leaders in their desperate election-year drives for votes. But these adjustments cannot eliminate the damage entirely. Minimum-wage legislation makes it more difficult for young workers to follow our rules into a more prosperous future.

An Explosion of Opportunities

We could go on virtually without end talking about how this or that policy impairs the incentives for Americans to live by our rules. We've offered a sampling of how policymakers should begin to think about the policies they devise. Our most general admonition is for policymakers to understand that nearly everything they do has long-run consequences, mainly because they affect how people live and plan their lives.

More than anything, policymakers and politicians need to acquire a new faith in the future of the American economy and people. They need to pay less heed to political pundits who argue that the future for most Americans looks dim because their economic opportunities are collapsing rapidly. We would like to conclude on a far more optimistic note. The country's future is bright mainly because opportunities for Americans (as well as other ordinary people around the world) are expanding rapidly!

More than anything, policymakers and politicians need to acquire a new faith in the future of the American economy and people.

The economic angst we know many Americans must feel from time to time, based as it often is in job insecurity, is grounded, paradoxically, in unbounded opportunities. The prosperity yet to unfold for this country will be founded in rapid changes in technology, in rapid expansions of markets, and in greater restrictions on government's ability to pass out special favors that in the short run require constant adjustments by people.

A hundred years ago, the eminent American historian Frederick Jackson Turner argued that the uniqueness of American economic and political life could be attributed to the unexplored and undeveloped western territories. Until the end of the 19th century, the West provided an array of resources and opportunities that could be tapped and exploited. Americans discontented with life in the East could use the West as an escape valve to a new life unencumbered by firms and governments which might otherwise be bent on exploiting workers and taxpayers.

Americans became enterprising individualists, according to Turner, partially because they could escape to the western territories, out of the reach of taxes and controls. He reasoned that the closing of the West (officially declared in 1890 by the Census Bureau because it could no longer identify a "frontier") would eventually give rise to social unrest, primarily because there would be no more escape valves, no more "free land" and the opportunities that go with land. Generations of Turner's students were pessimistic; many were convinced the closing of the West would require collectivist solutions for social problems. Modern critics of the American economy remain infected by the pessimism embedded in the Turnerian thesis.

Government has a responsibility, not to solve problems for people, but to create a productive environment in which people can solve their own problems.

Turner and his followers assumed that, outside political solutions, unexplored opportunities could only be found in so many unclaimed square meters of ground. They correctly identified the "closing of the West" when it was fully settled in practically all parts by the end of the 19th century. They did not, however, anticipate the development of the microchip, or any number of other modern technologies that have opened up a vast explosion of new opportunities.

Americans today have more frontiers

open to them than their grandparents or great-grandparents could possibly have imagined. As they venture forth into these new "Wests," they have more real income, more real physical and human capital, more technology, a greater safety net, and more time (given that the length of their workweek continues to fall and their life expectancy continues to rise). This translates into more opportunity for people to take control of their lives and empower themselves by following a few basic rules for successful living.

Government has a responsibility, not to solve problems for people, but to create a productive environment in which people can solve their own problems. The best way for government to create such an environment is by reducing its taxing, spending, and control over private decisions, allowing the American people more opportunity to live free and responsible lives.

Notes

1. See Richard B. McKenzie and Dwight R. Lee, "Getting Rich in America: A Few Easy Rules to Follow," Contemporary Issues Series 89 (St. Louis: Center for the Study of American Business, January 1998).
2. One should realize that when the highest marginal tax rate was 90 percent, the tax code was riddled with "loopholes," or ways by which people could legally avoid taxes. This means that the high marginal tax rate induced many Americans to waste their time and resources trying to avoid taxes. Of course, rich Americans also had to pay an array of other taxes, including state and local income taxes, sales and property taxes, and Social Security taxes.
3. When the highest tax rate was lowered to 28 percent, many tax loopholes were eliminated, which means that more income was subject to taxation.
4. The Congressional Budget Office estimates that in 1995, the 5 percent of American families who had an average income of $250,000 paid about 32 percent of their income in federal and state income, Social Security and Medicare taxes, and corporate income and excise taxes. The rich paid 26.7 percent of their income in taxes a decade earlier (as reported by David Wessel, "Again, the Rich Get Richer, but This Time They Pay More in Taxes," *Wall Street Journal*, 2 April 1998, p. A1).
5. Welfare programs are based on the assumption that it is cheaper for two people to live together under one roof than to live separately under two roofs, which explains why welfare payments for people living together is less than the payment received by a single person living alone. Hence, a couple can receive more benefits if they don't get married (or get divorced if they are married) and live apart (or pretend to live apart). Charles Murray's classic study of the welfare system *Losing Ground: American Social Policy, 1950-1980* (New York: Basic Books, 1984) describes in detail the counterproductive incentives built into the welfare system that led to the dramatic rise in illegitimate births in the 1960s. David Blankenhorn argues that one reason for the rise of "fatherless America" has been the fact that the dependency of the family on the support of the father has diminished with the development of public assistance, which can rise when the father leaves the family. Moreover, fathers (and often mothers) can presume that their duties to provide for their children can be taken over by the state in their absence [See *Fatherless America: Confronting Our Most Urgent Social Problem* (New York: Basic Books, 1995)].

6. See “Higher Asset Limits can Help Break Poverty Cycle,” Commentary, *Austin American Statesman* (May 20, 1992) p. A12.

7. For evidence that lower marginal tax rates have led to increased tax revenue, see Lawrence B. Lindsey, *The Growth Experiment* (New York: Basic Books, 1990).

8. For a history of Social Security, see Social Security Administration, *Social Security: Brief History*, as found at www.ssa.gov/history/history6.html.

9. Pete du Pont, “Social Security Bargain with Current Workers Can Save System,” *Dallas Morning News*, 9 March 1998, p. 11A.

10. For a review of the growing financial problems in the Social Security system, see John C. Goodman and Dorman E. Cordell, *The Nightmare in Our Future: Elderly Entitlements* (Dallas: National Center for Policy Analysis, January 1998).

11. As reported by Richard W. Stevenson, “To Social Security Critics, the Argument Is Simple,” *New York Times*, March 2, 1998, p. A1 and A13.

12. William W. Beach and Gareth G. Davis, “Social Security Shortchanges Minorities,” *Los Angeles Times*, 9 February 1998, p. B11.

13. Martin Feldstein, “Social Security and Saving: New Time Series Evidence,” *National Tax Journal*, June 1996, pp. 151-64.

14. See Isaac Ehrlich and Jian-Guo Zhong, “Social Security and the Real Economy: An Inquiry into Some Neglected Issues,” *American Economic Review*, May 1998, pp. 151-57.

15. Ibid.

16. These arguments and studies are reviewed by Richard B. McKenzie, *Times Change: The Minimum Wage and the New York Times* (San Francisco: Pacific Research Institute, 1994).

17. See Walter J. Wessels, “Minimum Wages: Are Workers Really Better Off?” (Paper prepared for presentation at a conference on minimum wages, Washington, D.C., National Chamber Foundation, July 29, 1987).

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Drawn from

Getting Rich in America:
A Few Easy Rules to Follow,

Contemporary Issues Series, Number 89,
published by CSAB in January 1998,

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