

# Olivia S. Mitchell



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Olivia Mitchell is International Foundation of Employee Benefit Plans Professor; Professor of Insurance and Management; and Director, Pension Research Council and Boettner Center for Pensions & Retirement Research, The Wharton School, University of Pennsylvania. She recently talked with J. Mark Poerio, a Partner with Paul, Hastings, Janofsky & Walker LLP, about Social Security and the retirement system in the United States.

**J. Mark Poerio: What is your impression of the overall health of the U.S. retirement system, first from the side of workers?**

**Olivia Mitchell:** My assessment is not a positive one. We have on the one hand the dramatic aging of the population, though it is not as bad here as in Europe. The aging is occasioned by relatively low fertility and long life expectancy, and at the same time, people are not really working much longer. So folks are spending longer and longer in the retired state, and the unfortunate fact is that it costs a lot of money to live for a long time not working. That is on the demand side for retirement savings.

On the supply side, we have a serious problem facing us with regard to Social Security, which is going to be running short of cash within 12 years and keep getting worse after that. Many extremely pessimistic defined benefit plan providers have terminated or frozen their plans, and quite frankly, I fear that many more are just waiting to freeze their plans the moment it becomes opportune.

The one ray of light in all this is the defined contribution arena; more active workers are now covered by these plans than by defined benefit plans. The assets in defined contributions slightly exceed defined benefit assets. That has been the area of growth over the last 20 years. But on the whole, the picture to me doesn't seem to be a very optimistic one.

**Where do you see the solutions? You mentioned defined contribution, but is that solution through our own education and savings?**

What I tell my students, somewhat tongue in cheek, is just don't get old, don't get sick, and don't retire. If you

take that attitude, I think you'll make a much wiser set of decisions than if you take a different perspective. Students should anticipate that, when they go to school, they are training not for one career but for multiple careers. In fact, they might have to return to school and be retrained.

Many people I've talked to who are in their late 40s or early 50s say, "There is no point in learning the new computer software or the new hardware or the newest management skills because I'm going to be retiring soon." That is absolutely the wrong attitude. People must recognize that they will work until 70 or 75. The point is that society has to move away from the notion that people should retire in their mid-50s or late 50s. We will all have to work another 10 to 15 years after that.

**What do you think of President George Bush's proposal for individual accounts?**

I served on the President's Commission to Strengthen Social Security in 2001. The bipartisan group of eight Democrats and eight Republicans was co-chaired by Sen. Patrick Moynihan and Dick Parsons, who is now the CEO of AOL Time Warner. Our group proposed a series of reforms that included personal accounts but was not limited to them. Our take on the problem was that we have a few years during which there is still enough cash to pay retirees. Within 12 years, the cash coming in will be insufficient to pay the full promised benefits.

People have this image of the python that swallowed an elephant, and they see that as a metaphor for the de-



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mographic bulge. They seem to think that once the baby boomers get through, there won't be a problem anymore. In fact, that is not true, because we move to a permanently older population with a permanently smaller group of young workers.

The Commission proposed personal accounts as a voluntary piece of Social Security reform. The Commission went further and proposed reformulating the first pillar of Social Security—the defined benefit piece, if you will. The current system is indexed to wages, which typically grow faster than prices. We proposed a system that would index benefits to prices. Benefits would never be cut; they just wouldn't grow as quickly as wages.

**You cap the liability that way?**

That would ensure system sustainability. Benefits would grow less slowly than under the current formula, so eventually the system would be solvent. Of course, you can reform Social Security without personal accounts, but the Commission's view was that personal accounts should be a voluntary part. Under one of the Commission's proposals, if a person decided he wanted an account, one-third of his payroll taxes would be invested. Then the retiree wouldn't be entitled to as big a first-pillar benefit because he or she hadn't paid in the full freight. So there would have to be some kind of offset in recognition of the fact that he hadn't paid over his lifetime the same amount as someone who paid in a full contribution.

The Commission issued its report in 2001, during the president's first term. But because we had 9/11, Enron, the stock market crash, and we were starting the war, it was not a good year on many fronts. The president said he would bring up Social Security as the top domestic priority if he was re-elected. In his first State of the Union message after he was re-elected, the president announced that Social Security reform was at the top of his domestic agenda. Since then, he has been barnstorming the country trying to convince people of the merits of his plan.

My sense is that people in Congress are starting to link Social Security reform with pension reform. This linkage may be very positive in terms of trying to get something done in Congress because of the problems confronting defined benefit plans. That may create enough momentum to push the whole thing through.

**Do you think the president's proposal is as thorough as what your commission was contemplating, and will it get the job done?**

The administration has been somewhat clear in its depiction of the personal accounts, and in many regards, the president's plan and our proposal are quite similar. Where the president has not been very specific so far is in detailing the proposed reforms to bring the rest of the system back into balance—the types of changes he would favor for fixing the first-pillar defined benefit piece. He has talked some about price indexing; he has talked about a progressive indexing idea, which is a little bit of price indexing and a little bit of wage indexing, and so forth. The main thing he says is definitely off the table is raising the payroll tax, which is consistent with what we proposed.

**Is there discussion of changing the formula for the wage-based limit to go above where it is now at \$90,000 or to raise the cap?**

One proposal that has been discussed, not in the administration but in the rest of the country, is to either raise the taxable cap or limit the cap altogether. There seems to be some wiggle room around Capitol Hill. I don't think changing the limit is a good idea for a couple of reasons: One, if you raise the taxable cap, then people are going to get more benefits, so it doesn't get you out of the hole; and two, it buys just six years of cash flow solvency, that is it. So who are we kidding? As you probably know, the Medicare tax is uncapped. You pay Medicare tax on that last dollar of earnings all the way up. At the end of the day, if you want to keep Social Security focused on people in the lower and middle classes, then raising the tax, and therefore raising the benefits that the upper classes get, is not that helpful.

**Are you optimistic that educating individuals is going to get us where we need to go? Or do you think the government needs to be more paternalistic?**

There is the issue of what the government should do and there is a separate issue of what employers should do. We have a large group of older people that is going to be extremely expensive to take care of. And we have a relatively small group of young folks working. You know the statistics: It used to be 13 workers supporting a retiree; it is now 6; it will be 2.2. The question becomes what are workers willing to pay? At what point do we worry about people working off the books and

in black market labor? If an employee is going to pay 20 to 25 percent in payroll tax—and we haven't even mentioned Medicare yet—it is going to be very punitive to go to work, so people will work less.

Economists say providing benefits to all people is going to be increasingly difficult. Given that, my perspective is that the government should try to structure a system that focuses on people who have very little. Right now, Social Security benefits are often insufficient to get a person up to the poverty line; a minimum wage worker who has paid in his or her whole life receives benefits that are below poverty. That is the place to start. Our Commission proposed raising the benefits of low-wage earners who worked a lifetime to 20 percent above the poverty line. Focusing on those people is probably the right role for government.

**Where did you get the money to pay for it?**

The Commission's proposal raised benefits for people at the bottom and reduced the growth rate for everybody else. Benefits weren't cut, but the rate of growth was cut. We projected some increase in productivity. So as productivity increased, as the wage base increased—about 1 percent per year in real terms after inflation—that would be enough to pay for the system going forward.

**What do you think plan sponsors should be doing?**

This is a really interesting question. When I started teaching benefits 25 years ago, about half the private-sector workforce had pensions; public sectors have always had more pensions and still do today. These questions arise: Why don't the rest of the folks have pensions, and who is going to take care of them? One reason people don't have pensions is that the Social Security system has been relatively generous to them. If you are earning minimum wage, would you rather save a dollar or consume a dollar? It makes no sense to save at the margin if you have a safety net of sorts—Medicaid if you become indigent and need medical care, Social Security if you become disabled. We have many social insurance schemes that may not be hugely generous but do pick a person up in the event of disaster. For people in the bottom third of the income

distribution, saving often doesn't make sense. In fact, they are penalized by welfare if they save.

Those safety nets have an effect up the income distribution ladder as well. For example, people are not buying nursing home insurance, even though nursing home care costs \$60,000 to \$70,000 a year. The very rich can self-finance it; the very poor can get Medicaid. Those in the middle are choosing to take their chances. The structure we have has to focus on doing a good job for the people in need and saying to other folks, "You're on your own if you want more than something minimal."

**In our consumer-driven economy, it is very difficult for an employer to force plans down employees' throats. I can see the benefit of paternalistic employers, but I am not sure force works well in our economy.**

About half the workforce now doesn't have a pension. When I started teaching, 80 percent of employers had defined benefit plans and 20 percent had defined contribution plans. Now the numbers have flipped. During the go-go years of the '80s and '90s, people with defined contribution plans saw their accumulations go up, and people with defined benefit plans felt like chumps. They didn't perceive the value they were getting.

Labor mobility has dramatically changed with women entering the labor market. Lifetime jobs don't exist anymore. As people started changing jobs, they didn't want to leave behind a lost pension or maybe a vested pension from an employer that they wouldn't be able to get for 40 years. They wanted to take the money and manage it. Defined contribution plans became quite popular.

**What about from a labor and tax policy side? Do you think the government should be trying to encourage defined benefit plans, or should the system that is in place now be left alone?**

The defined benefit system is in serious trouble. It can't be left alone. As you know, there have been a number of very highly publicized bankruptcies in the airline industry in the last year. Those bankruptcies have an inevitable domino effect. As soon as any big company decides to off-load its pension obligations and retiree health care, then to meet that cost margin, others in the industry will also want to unload their pension and retiree health obliga-

tions. That has happened in steel over the last 15 years. It is currently in progress in the airlines, and the auto industry may be the next to go.

**Could you briefly touch on the legal responsibilities of a company regarding its pension liabilities?**

The interesting thing is that 2004 was the 30th anniversary of ERISA (the Employee Retirement Income Security Act), which is the pension law. What led to ERISA were situations quite similar to what we are seeing today. An auto company, Studebaker, went broke in the mid '60s and had an underfunded pension plan, and the retirees ended up short. They marched on Capitol Hill and said, "You have to fix it." Ten years later, ERISA was passed, and officials thought they had the answer. They thought they had rules that would force companies to fund their plans. They thought they had sufficient transparency that the relevant stakeholders would actually know whether the plans were being funded, and the crowning jewel of the whole enterprise is the PBGC (Pension Benefit Guaranty Corporation). This government insurance protects company defined benefit plans when the sponsoring employer goes bankrupt. But government officials didn't know how to price the insurance, and they didn't do a very good job of it. There was a lack of transparency, there was a lot of accounting murk and a lot of actuarial lack of clarity, and as a result, shareholders really didn't know what was happening in their plans. In fact, it is illegal for the government to release the information a corporation provides to the PBGC every year on its true underfunded status.

**How is the government trying to fix it?**

Government officials are doing a number of things. To make the statement of both assets and liabilities in the defined benefit plan more transparent, there is an effort to get companies to mark everything to market. Before, everything was smooth. A company could smooth its assets over five years, so even if it lost money three years ago, the loss wouldn't be reported or reflected clearly until quite a bit later. That doesn't reflect true funding. They also let companies use expected rates of return, which bear little resemblance to reality. So all this contributed to make companies look healthy in the times of capital market volatility and downturns such as these we saw in the last five years.

The administration is also proposing to raise premiums for pension insurance. The premium has two parts—a fixed piece and a variable piece. The fixed piece is \$19 per worker per year, and Congress seems likely to raise it to \$30. The variable piece has been there in the past, but it will be structured more sensibly. The plan is to make the variable portion a function of how underfunded a company is and the credit status of the plan sponsor. So if the plan sponsor has been downgraded to junk bond status, as some of the auto companies recently have been, then the plan sponsor is going to have to kick in a lot more money to the plan because it is at most risk of going bankrupt and giving the plan to the government.

Also proposed is that if the sponsoring company looks like it is getting into trouble—is headed toward bankruptcy or its credit rating is falling—then active workers will no longer be permitted to accrue new benefits. As you might imagine, that has unions up in arms. They are saying, "Wait a minute, this is part of compensation, and you're not letting us get it." But the government's response is, "Why should we let risky companies that probably aren't going to be able to pay their bills accrue new obligations?" That's probably a step in the right direction.

**Do you see the role of the PBGC changing dramatically from today?**

The PBGC is also facing insolvency, with an underfunded liability of about \$25 billion. When United Airlines went bankrupt, the PBGC took on the additional liability, which was twice the size of any previous company, of about \$7 billion. The PBGC has dozens of other companies that have gone broke over the last few years and have put liabilities on the government's shoulders. The PBGC has some assets, but if you compare its assets to the benefits it is already obliged to pay, the PBGC is short by about \$25 billion. And there are dark clouds on the horizon. I've heard that the projected underfunded liability if you take into account future bankruptcies may be about \$450 billion. Defined benefit plans are not as safe as they once seemed.

**Would a shortfall of \$450 billion go back to the taxpayers?**

Not technically. The PBGC is not, on paper, backed by the full faith and credit of the federal government. There is no discussion about what would happen if PBGC went

broke. Nonetheless, I feel a hand in my pocket. We saw what happened in the savings and loan deal. If the millions of retirees who are getting benefits from the PBGC today don't get their payments, then you can be quite sure there is going to be some effort to bail out the PBGC.

Some people have asked whether the defined benefit system is insurable at all: If an insurer similar to the PBGC could start from scratch and didn't have huge, unfunded liabilities from the past, could it do it right? It is not obvious that that is possible, because the insurance would have to be priced. A better way would have been to have the private market, not the government, insure benefits.

At this point, unfortunately, almost nobody has started a new defined benefit plan. There have been some conversions, some cash balance plans, and so forth. The number of plans is falling, and the number of active workers is going south—who would be foolish enough to start a defined benefit plan today knowing there is potentially \$450 billion the plan may have to help carry? Defined benefit plans are proving to be extremely risky.

#### **And they are insured by the PBGC.**

Right, but the United Airline pilots were anticipating \$120,000 a year in benefits, and now they are getting \$28,000. Insured benefits are capped and are reduced for early retirement.

#### **I'm thinking of the disconnect between the reality and the perception of defined benefit plans.**

Everybody bears a share of the blame. The CEOs and the CFOs 20 to 40 years ago who offered these plans probably didn't know what they were getting into. The same goes for retiree health insurance. Twenty years ago, companies provided retiree health benefits, sometimes negotiated in the union setting, sometimes not. Then, for the last ten years, retirees' benefit costs have been going up at double-digit rates. Companies didn't know 20 years ago what retirement benefits were going to cost; if they had, they wouldn't have provided them *carte blanche*. Management and unions bear some blame for not foreseeing the problem in a more timely way, and shareholders have not been able to judge the true risk of the companies they purchase. It has been a bath of cold water for just about everybody.

In the United Kingdom, two-thirds of all defined benefit plans are either terminated or frozen. That is further than the United States has gone. U.K. companies are in worse trouble because they were more heavily in equities and therefore suffered more when the stock market tanked. But there is a move to clean up the accounting. In the U.K., defined benefit plan sponsors are now required to mark to market their assets and liabilities frequently. So companies are starting to think that defined benefit plans are volatile and expensive, and many are shutting down.

#### **Internationally, are companies being more aggressive in protecting pensions than U.S. companies?**

The United States has been the most aggressive in protecting defined benefit plans by setting up the PBGC 30 years ago. However, we have seen its problems. The U.K. interestingly enough set up an institution virtually identical to the PBGC this year. Already it has suffered financial problems because it had all the same difficulties we just talked about in the U.S. case. I find it disappointing that the lessons weren't learned or disseminated more broadly. In many other countries, there is no protection for a defined benefit plan that goes broke. Or if there is, it is a minimal solvency fund that the industry agrees to pay into as long as it can. In Japan, the defined benefit environment is terribly underfunded. Companies don't have a government backstop.

Chile privatized the whole social security system back in 1980 to '81. It is a mandatory defined contribution system; every worker in the wage and salary sector has to pay 10 percent of his or her pay each month. Workers can choose which money managers to manage the money. They are private money managers who compete with each other. There is clear reporting to a central supervisory agency.

The system has been around now 25 years, and people are starting to retire from that system. That is really the proof of the pudding. You can't judge a pension system based on just one or two years. You have to see how it does long term. People in Chile who are in the pension system seem to appreciate and like it and seem to have a fairly good understanding of what it is about. The main critique I've heard is that only about 60 percent of the workforce is covered by the pension system. Certain sectors are exempt. Workers who are self-employed or in agriculture don't have to pay in. There are many workers

outside the formal sector labor market. Don't forget that Chile is still a fairly poor country. People who sell things on street corners are not covered by the pension system. However, they weren't covered by the old system either.

In addition, the Chilean model is a multi-pillar system. A Chilean who is old and poor can still get a government welfare benefit. When people talk about Chile's pension, they often say it is all privatized. A lot of it is, but it still has some assistance for those whose life didn't go very well. I think that is what the rich countries are always going to have to have as well. There has to be a minimum, some kind of safety net, to help the poor; above that is where the wealth-building capacity is.

The Australian system is similar. It is mandatory: Workers must pay in 9 percent of their salaries every month. A difference between Australia's system and Chile's is instead of having just a few big money managers compete for money, Australia has employer-based pensions. So every employer designs the plan that is best for the company's workers. It could be a defined contribution plan, or it could be a defined benefit plan. So the Australian system is an example of a very flexible structure where the type of plan varies with the job in the company an employee works for. But everybody has to be covered.

**Then are we back to a plan in which the government mandates how workers contribute to their retirement?**

That goes back to the question "Why do we have pensions and Social Security at all?" The problem is that in a society with no provision at all for old age, some folks are going to have their hands out and say, "Please feed me; I have nothing." If you know that is going to be the case, then you have to set up a system with some precautionary savings built in so that everybody will have something.

**What are the implications for the U.S. economy from the underfunded pension system? Is there a day of reckoning coming soon?**

We are in better condition than many other countries. A country has to have about 2.2 babies per woman to have zero population growth. In parts of Japan, the rate is now below 1. In Italy, it is 1.2, and in Spain—a very Catholic country—the rate is also 1.2. The number of potential workers in those countries is shrinking. The United States has a replacement population fertility level of about 2.2. The main reason is we have a lot of immigrants, so we are very fortunate in that

regard. That is the workforce of the future. But the United States doesn't have a consistent retirement policy or an immigration policy that nicely dovetails into a retirement policy. It would be ideal if we could structure an immigration policy so that it could attract and retain the right kind of people for the next generation. Instead, our immigration policy is focused on political reasons or family reunification. People bring in their grandparents and great-grandparents, which is lovely, but that is not going to help our Social Security problem. So we need to rethink our immigration policy as we rethink our retirement policy.

**Your answers sound long term and do not suggest we have a huge short-term problem. Is the economy already taking these issues into account?**

In the next year, there are likely to be measures to try to keep the PBGC going, at least on an interim basis. I'm concerned about making some short-term fixes that prove expensive in the long run. I feel the same way about Social Security. There may be a short-term fix here or there, but the politicians' inevitable temptation is to let somebody else handle it down the road. Fixing it would be much easier now while we have freedom to tweak the retirement age a little bit, put in personal accounts, and do a little of this and that. Then everybody has a chance to plan and anticipate and make allowances and be flexible. That, I think, is the right approach. If nothing gets done with Social Security or with the PBGC this year, I don't think there will be an immediate crisis. But the problems will just get worse the longer we wait.

The Medicare problem dwarfs everything else. The unfunded liability of Social Security is about \$11 trillion in present value—the size of the U.S. gross domestic product. The unfunded liability for Medicare is about \$60 trillion. That is the amount of benefits promised to current and future retirees above and beyond the payroll taxes dedicated to pay for it. That is going to be nasty, because Grandma is going to be lying in the hospital needing cancer treatment, and it is going to be hard to say no.

We have very little time, and we should get started fixing the problems now. In the meanwhile, just don't get old and don't get sick and don't retire.

**Good advice; we'll follow that. ■**