Our children may have to work until they’re 85, as life expectancy will move beyond 100 and pensions will be woefully inadequate, says Olivia Mitchell, a leading pension expert at the Wharton School of the University of Pennsylvania. Mrs Mitchell argues that underfunded US pension plans will require sizeable benefits cuts and tax increases, and that the bankruptcy playing out in Puerto Rico could set a precedent for how US municipal debt defaults are dealt with in future.

Olivia Mitchell spoke to Beat Siegenthaler of the UBS Knowledge Network in Zurich on the fringes of an event at the Swiss Finance Institute on May 29.

Beat Siegenthaler: In your recent book Reimagining Pensions: The Next 40 Years you say that ‘the [US] corporate pension scene today is in turmoil’. What are the main issues?

Olivia Mitchell: Europeans are often unaware of how fragmented US financial regulation is. For example, each of our 50 states has its own insurance regulation, which makes life complicated. Also, the federal government does not require common accounting, reporting and solvency standards across all financial entities. Consequently, for pensions and insurance the US regulatory environment is extremely complex and quite poorly integrated.

In the wake of the global financial crisis, the Obama administration and Congress did adopt a series of new laws and rules to streamline the regulatory environment. Yet President Trump has promised to undo many of these, and at present no one knows quite what the Trump administration will keep, change, or get rid of. This makes the US extremely risky for anyone trying to save for retirement in company-sponsored pensions.

BS: What about the funding situation of US pension plans?

OM: In 1974 the US adopted federal regulations requiring corporate defined-benefit plans to fix their under-funding problems. But US state and local government pensions were not covered by this federal regulation, which is why they are very poorly funded today. For example, the City of Philadelphia pension plan
reports having only about 45% of the assets needed to pay promised retiree benefits. But that is based on a very high discount rate of 7.5%; if a more realistic discount rate were used, the plan may be only about one-quarter funded. Other cities and states face similar shortfalls. Stanford economist Josh Rauh has estimated that US state and local governments report unfunded pension liabilities of $1.4 trillion, but that using proper financial techniques the funding gap might be $3.9 trillion, or 279% higher!

Underfunded government plans are much in the news of late. The Commonwealth of Puerto Rico, technically an unincorporated territory of the US, recently declared bankruptcy, which was in part because the public pension fund has depleted its reserves and still owes billions in bond debt. Puerto Rico is not a state, but people are still watching carefully to see whether public sector pensioners will get a haircut -- and how large it will be. The resolution of lawsuits over Puerto Rican pensions will have ripple effects across the US public-pension landscape.

"Babies born today have a good chance of living to age 100 and older."

BS: What about defined-benefit plans in the private sector?

OM: Fifty years ago, US corporate defined-benefit pension plans were concentrated in manufacturing, airlines, railroads, and a few occupational groups, like the truckers that drive cargo across state lines. Many of these pension plans were poorly funded and many are now frozen, which means they do not admit new workers, who instead get defined-contribution plans. So there’s a difference in benefit expectations between older workers and retirees, versus new hires. Underfunding happens because corporates don't contribute the so-called ‘required’ amounts, or because the funds lost money by investing in risky assets. Another problem is that low interest rates push up the cost of the benefits promised with defined plans. In 2015, only 20% of Fortune 500 firms still offered defined-benefit plans to new workers, down from 48% a decade before.

BS: How will the underfunding problem be solved?

OM: The US has a government-sponsored insurance scheme run by the Pension Benefit Guaranty Corporation. But this institution is itself seriously underfunded and it will be unable to pay all promised benefits within an estimated 10 years. In particular, there is no full-faith credit backing provided by the US government. If a corporate pension fund goes bust, only a relatively small amount of the defined benefit is secured, and even that amount may not be paid out. Moreover, there is little enthusiasm to raise taxes – indeed, the new administration wants to cut them. As a result, the corporate defined-benefit pension sector is facing big trouble.

BS: Puerto Rico is interesting because it will create a precedent as to how the US government may react in case of an entity going bust?

OM: Exactly right. We have already seen some cities cutting public pension workers’ benefit in
bankruptcy, with Detroit a well-known example. Cleveland, Central Falls (Rhode Island) and New York City have also undergone bankruptcy in the past, and many retirees saw their benefits trimmed back. There is no precedent for US states filing for bankruptcy, yet some have argued that this may be the only way to begin resolving state financial shortfalls, including the pension gaps. Of course, this is one reason why the Puerto Rico case is so interesting. It could be a harbinger of what will happen in the future.

BS: So ultimately the question is a political one of who has to pay?

OM: Yes, pensions are always a political issue, but the question is at what point will somebody higher up actually start paying attention? State governments in the US have a great deal of autonomy, as they can decide how much to tax and how much they wish to pay in benefits – as long as they have a budget. Conversely, the federal government cannot tell states how generous their pensions should be, or how much they have to tax in order to meet funding requirements.

Nevertheless, the media and public opinion are beginning to notice. When the city of Detroit went bankrupt in 2013, one proposal was that the local Art Museum should sell works by Matisse, Rembrandt, and Van Gogh to raise money for the public employees’ pension fund. In the end this was not necessary, but Detroit pensioners still had their benefits cut by about 5%. Puerto Rico’s pensioners could experience much larger cuts. California is also beginning to acknowledge its massive public pension plan underfunding, and some municipalities have already felt 63% benefit cuts.

BS: So there is a tension between applying haircuts and raising taxes?

OM: Yes, and to complicating things, some US states have a constitutional requirement to pay public-sector retirement benefits. So unless they change the constitution, which is a huge job, benefits to retirees are sacrosanct. In such cases taxes will need to rise if no other funding sources can be found.

The interesting question then is, will taxpayers vote with their feet? For example, can the taxpayers of Illinois, who might be confronted with a big pension-related tax increase to pay for the pensions, simply slide over the border to the next state? The problem is this will not work if potential future tax increases are capitalized into property values. In other words, those seeking to avoid paying taxes may find their home values have dropped as the market realizes that future income and property tax streams will need to rise much more than previously expected.

BS: What does all this mean for the US municipal bond market?

OM: Puerto Rico is a very interesting case because its bonds enjoyed tax-favored status, just like municipal bonds. The rating agencies paid little attention to pension and retiree medical insurance obligations when judging these bonds’ safety. A wide range of investors bought the bonds to take advantage of the tax benefits, and these include retirees and insurers, as well as mutual funds. The question is what the stakeholders will get as Puerto Rico’s bankruptcy plays out.

BS: Just taking a step back, why were defined benefit plans so popular with corporations initially?
OM: In the US, it’s voluntary for a company to offer a pension, and during the Second World War pension plans were mostly adopted in the unionized sector – railroads, auto companies and heavy manufacturing. During a period of wage-price controls, these industries received government permission to raise compensation by promising pension benefits to attract workers. At the time, corporations had few older workers and they didn’t worry about rising retiree longevity and medical costs. But 70 years later, few heavy manufacturing and auto companies survive, and those that do have many more retirees than active workers. So now, the pension ‘tail’ is wagging the corporate ‘dog’.

Another reason that defined benefit plans went into decline in corporate America is that the labor market has changed dramatically. In the old days, one worked an entire career at, say, Ford Motor Company, and retired with a defined benefit income stream for life. Today, people move around much more: the typical young US worker can now expect jobs at 15 different companies over a career. What they want is a portable retirement scheme that they take with them as they move.

A question I am researching at present is how to bring the best features of the defined benefit plan into a defined contribution world. My recent research explores how to integrate payout of deferred annuities into 401(k) plans, which are the normal US defined contribution vehicle. We show that employers can default workers into a deferred lifetime annuity with 10% of their defined contribution accounts at 65, and the annuity begins paying from age 85 until death. This is a very inexpensive way to “put the pension back” into defined contribution plans.

"Growth requires more workers, not fewer."

BS: How do things look outside the US?

OM: The World Economic Forum just issued a report entitled We'll Live to 100 – How Can We Afford it?, exploring pension underfunding across the OECD. It indicates that by 2050 each person in the OECD would owe $300,000 just to fund the unfunded pension liability. With few exceptions, longevity has been increasing virtually everywhere, and fertility has been stagnant at best. This must imply that people will need to work longer, and we must launch these conversations immediately.

BS: Telling people that they have to work longer is a difficult topic of conversation.

OM: Yes it is certainly true that many groups resist the idea of later retirement. Over the years governments have encouraged people to believe that they can be taken care of from a relatively young age – 50 or 55 or 60. And no one has explained that it’s going to be extremely expensive to support early retirees, particularly as many will live to 100 or beyond.

And, by the way, demographers tell us that babies born today have a good chance of living to age 100 and older. We must teach our children that they may need to work until they’re 85. This new perspective will make us rethink everything we believe about timing and nature of education, on-the-job skill training, and investment in physical and mental health, friendship, marriage, community, and more.

Moreover, when we look at countries that provide generous early retirement benefits, we
find that these are also the nations with very high youth unemployment and youth underemployment. The reason is that paying people to retire early requires high taxes, which in turn damages work opportunities for the young. It is time to do away with the old notion that there is a fixed number of jobs and that we should pension-off older workers. To the contrary, growth requires more workers, not fewer!

BS: What could be some constructive ways to deal with the problem?

OM: I have recently examined a plan to give older workers an incentive to remain employed longer, rather than claim their social security benefits at a young age. In the US, as in many countries, the old-age pension rises the longer you wait to claim it. This higher benefit is paid as an annuity, a monthly payment for the rest of one’s life. As an example, if someone claimed at age 62, she might get her basic benefit of $1,500 per month. But if she waited to claim benefits at age 70, she would receive 77% more in monthly benefits, or $2657 per month from that age forward.

Our reform would provide the benefit increase in the form of a lump sum, instead of the higher monthly benefit. In our example, the lump sum would be $178,000 at age 60, which would be paid along with the basic benefit of $1,500. We are convinced that the lump sum would incentivize many people to work longer and claim later. In other words, the incentive is a carrot, not a stick.

BS: I guess old age is not a very sexy topic for most people, it’s not something people want to think about.

OM: We need to encourage people to think about themselves in a life cycle context. For instance, we need to teach children about financial concepts in school, if they are going to make sensible decisions about credit cards, mortgages, investment in education and saving for retirement. In some US states, the local governments have mandated financial literacy training in high schools, and we see that young adults that are taught these concepts develop financial plans, save more, and build bigger retirement accounts. So it can work!

A failure to teach the young can lead to financial disaster. For instance, many young Americans have taken out massive student loans that they cannot easily pay back. They also use credit cards and pay only the minimum each month, leaving them in debt at high interest rates. And they take on expensive car loans, mortgages, payday loans, and other forms of expensive debt. Greater financial literacy is a must for the next generation. Returns could be low for years to come, which combined with the very high chance of living to age 100 and beyond means people must save more, work longer, and expect less.

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