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The Risk Pool

What's behind Ireland's economic miracle—and G.M.'s financial crisis?

by Malcolm Gladwell

1.

The years just after the Second World War were a time of great industrial upheaval in the United States. Strikes were commonplace. Workers moved from one company to another. Runaway inflation was eroding the value of wages. In the uncertain nineteen-forties, in the wake of the Depression and the war, workers wanted security, and in 1949 the head of the Toledo, Ohio, local of the United Auto Workers, Richard Gosser, came up with a proposal. The workers of Toledo needed pensions. But, he said, the pension plan should be regional, spread across the many small auto-parts makers, electrical-appliance manufacturers, and plastics shops in the Toledo area. That way, if workers switched jobs they could take their pension credits with them, and if a company went bankrupt its

workers' retirement would be safe. Every company in the area, Gosser proposed, should pay ten cents an hour, per worker, into a centralized fund.

The business owners of Toledo reacted immediately. "They were terrified," says Jennifer Klein, a labor historian at Yale University, who has written about the Toledo case. "They organized a trade association to stop the plan. In the business press, they actually said, 'This idea might be efficient and rational. But it's too dangerous.' Some of the larger employers stepped forward and said, 'We'll offer you a company pension. Forget about that whole other idea.' They took on the costs of setting up an individual company pension, at great expense, in order to head off what they saw as too much organized power for workers in the region."

A year later, the same issue came up in Detroit. The president of General Motors at the time was Charles E. Wilson, known as Engine Charlie. Wilson was one of the highest-paid corporate executives in America, earning \$586,100 (and paying, incidentally, \$430,350 in taxes). He was in contract talks with Walter Reuther, the national president of the U.A.W. The two men had already agreed on a cost-of-living allowance. Now Wilson went one step further, and, for the first time, offered every G.M. employee health-care benefits and a pension.

Reuther had his doubts. He lived in a northwest Detroit bungalow, and drove a 1940 Chevrolet. His salary was ten thousand dollars a year. He was the son of a Debsian Socialist, worked for the Socialist Party during his college days, and went to the Soviet Union in the nineteen-thirties to teach

peasants how to be auto machinists. His inclination was to fight for changes that benefitted every worker, not just those lucky enough to be employed by General Motors. In the nineteen-thirties, unions had launched a number of health-care plans, many of which cut across individual company and industry lines. In the nineteen-forties, they argued for expanding Social Security. In 1945, when President Truman first proposed national health insurance, they cheered. In 1947, when Ford offered its workers a pension, the union voted it down. The labor movement believed that the safest and most efficient way to provide insurance against ill health or old age was to spread the costs and risks of benefits over the biggest and most diverse group possible. Walter Reuther, as Nelson Lichtenstein argues in his definitive biography, believed that risk ought to be broadly collectivized. Charlie Wilson, on the other hand, felt the way the business leaders of Toledo did: that collectivization was a threat to the free market and to the autonomy of business owners. In his view, companies themselves ought to assume the risks of providing insurance.

America's private pension system is now in crisis. Over the past few years, American taxpayers have been put at risk of assuming tens of billions of dollars of pension liabilities from once profitable companies. Hundreds of thousands of retired steelworkers and airline employees have seen health-care benefits that were promised to them by their employers vanish. General Motors, the country's largest automaker, is between forty and fifty billion dollars behind in the money it needs to fulfill its health-care and pension promises. This crisis is sometimes portrayed as the result of corporate America's excessive generosity in making promises to its workers. But when it comes to retirement, health, disability, and unemployment benefits there is nothing exceptional about the United States: it is average among industrialized countries—more generous than Australia, Canada, Ireland, and Italy, just behind Finland and the United Kingdom, and on a par with the Netherlands and Denmark. The difference is that in most countries the government, or large groups of companies, provides pensions and health insurance. The United States, by contrast, has over the past fifty years followed the lead of Charlie Wilson and the bosses of Toledo and made individual companies responsible for the

care of their retirees. It is this fact, as much as any other, that explains the current crisis. In 1950, Charlie Wilson was wrong, and Walter Reuther was right.

2.

The key to understanding the pension business is something called the "dependency ratio," and dependency ratios are best understood in the context of countries. In the past two decades, for instance, Ireland has gone from being one of the most economically backward countries in Western Europe to being one of the strongest: its growth rate has been roughly double that of the rest of Europe. There is no shortage of conventional explanations. Ireland joined the European Union. It opened up its markets. It invested well in education and economic infrastructure. It's a politically stable country with a sophisticated, mobile workforce.

But, as the Harvard economists David Bloom and David Canning suggest in their study of the "Celtic Tiger," of greater importance may have been a singular demographic fact.

In 1979, restrictions on contraception that had been in place since Ireland's founding were lifted, and the birth rate began to fall. In 1970, the average Irishwoman had 3.9 children. By the mid-nineteen-nineties, that number was less than two. As a result, when the Irish children born in the nineteen-sixties hit the workforce, there weren't a lot of children in the generation just behind them. Ireland was suddenly free of the enormous social cost of supporting and educating and caring for a large dependent population. It was like a family of four in which, all of a sudden, the elder child is old enough to take care of her little brother and the mother can rejoin the workforce. Overnight, that family doubles its number of breadwinners and becomes much better off.

This relation between the number of people who aren't of working age and the number of people who are is captured in the dependency ratio. In Ireland during the sixties, when contraception was illegal, there were ten people who were too old or too young to work for every fourteen people in a position to earn a paycheck. That meant that the country was spending a large percentage

of its resources on caring for the young and the old. Last year, Ireland's dependency ratio hit an all-time low: for every ten dependents, it had twenty-two people of working age. That change coincides precisely with the country's extraordinary economic surge.

Demographers estimate that declines in dependency ratios are responsible for about a third of the East Asian economic miracle of the postwar era; this is a part of the world that, in the course of twenty-five years, saw its dependency ratio decline thirty-five per cent. Dependency ratios may also help answer the much-debated question of whether India or China has a brighter economic future. Right now, China is in the midst of what Joseph Chamie, the former director of the United Nations' population division, calls the "sweet spot." In the nineteen-sixties, China brought down its birth rate dramatically; those children are now grown up and in the workforce, and there is no similarly sized class of dependents behind them. India, on the other hand, reduced its birth rate much more slowly and has yet to hit the sweet spot. Its best years are ahead.

The logic of dependency ratios, of course, works equally powerfully in reverse.

If your economy benefits by having a big bulge of working-age people, then your economy will have a harder time of it when that bulge generation retires, and there are relatively few workers to take their place. For China, the next few decades will be more difficult. "China will peak with a 1-to-2.6 dependency ratio between 2010 and 2015," Bloom says. "But then it's back to a little over 1-to-1.5 by 2050. That's a pretty dramatic change. Thirty per cent of the Chinese population will be over sixty by 2050. That's four hundred and thirty-two million people." Demographers sometimes say that China is in a race to get rich before it gets old.

Economists have long paid attention to population growth, making the argument that the number of people in a country is either a good thing (spurring innovation) or a bad thing (depleting scarce resources). But an analysis of dependency ratios tells us that what's critical is not just the growth of a population but its structure. "The introduction of demographics has reduced the need for the argument that there was something exceptional about East Asia or idiosyncratic to Africa," Bloom and Canning write, in

their study of the Irish economic miracle. "Once age-structure dynamics are introduced into an economic growth model, these regions are much closer to obeying common principles of economic growth."

This is an important point. People have talked endlessly of Africa's political and social and economic shortcomings and simultaneously of some magical cultural ingredient possessed by South Korea and Japan and Taiwan that has brought them success. But the truth is that sub-Saharan Africa has been mired in a debilitating 1-to-1 ratio for decades, and that proportion of dependency would frustrate and complicate economic development anywhere. Asia, meanwhile, has seen its demographic load lighten overwhelmingly in the past thirty years. Getting to a 1-to-2.5 ratio doesn't make economic success inevitable. But, given a reasonably functional economic and political infrastructure, it certainly makes it a lot easier.

This demographic logic also applies to companies, since any employer that offers pensions and benefits to its employees has to deal with the consequences of its

nonworker-to-worker ratio, just as a country does. An employer that promised, back in the nineteen-fifties, to pay for its employees' health care when they were retired didn't set aside the money for that while they were working. It just paid the bills as they came in: money generated by current workers was used to pay for the costs of taking care of past workers. Pensions worked roughly the same way. On the day a company set up a pension plan, it was immediately on the hook for all the years of service accumulated by employees up to that point: the worker who was sixty-four when the pension was started got a pension when he retired at sixty-five, even though he had been in the system only a year. That debt is called a "past service" obligation, and in some cases in the nineteen-forties and fifties the past-service obligations facing employers were huge. At Ford, the amount reportedly came to two hundred million dollars, or just under three thousand dollars per employee. At Bethlehem Steel, it came to four thousand dollars per worker.

Companies were required to put aside a little extra money every year to make up for that debt, with the hope of someday—twenty or thirty years down the line—becoming fully funded. In

practice, though, that was difficult. Suppose that a company agrees to give its workers a pension of fifty dollars a month for every year of service. Several years later, after a round of contract negotiations, that multiple is raised to sixty dollars a month. That increase applies retroactively: now that company has a brand-new past-service obligation equal to another ten dollars for every month served by its wage employees. Or suppose the stock market goes into decline or interest rates fall, and the company discovers that its pension plan has less money than it had expected. Now it's behind again: it has to go back to using the money generated by current workers in order to take care of the costs of past workers. "You start off in the hole," Steven Sass, a pension expert at Boston College, "And the problem in these plans is that it's very difficult to dig your way out."

Charlie Wilson's promise to his workers, then, contained an audacious assumption about G.M.'s dependency ratio: that the company would always have enough active workers to cover the costs of its retired workers—that it would always be like Ireland, and never like sub-Saharan Africa. Wilson's promise, in other words, was

actually a gamble. Is it any wonder that the prospect of private pensions made people like Walter Reuther so nervous?

The most influential management theorist of the twentieth century was Peter Drucker, who, in 1950, wrote an extraordinarily prescient article for Harper's entitled "The Mirage of Pensions." It ought to be reprinted for every steelworker, airline mechanic, and autoworker who is worried about his retirement. Drucker simply couldn't see how the pension plans on the table at companies like G.M. could ever work. "For such a plan to give real security, the financial strength of the company and its economic success must be reasonably secure for the next forty years," Drucker wrote. "But is there any one company or any one industry whose future can be predicted with certainty for even ten years ahead?" He concluded, "The recent pension plans thus offer no more security against the big bad wolf of old age than the little piggy's house of straw."

3.

In the mid-nineteen-fifties, the largest steel mill in the

world was at Sparrows Point, just east of Baltimore, on the Chesapeake Bay. It was owned by Bethlehem Steel, one of the nation's grandest industrial enterprises. The steel for the Golden Gate Bridge came from Sparrows Point, as did the cables for the George Washington Bridge, and the materials for countless guns and planes and ships that helped win both world wars. Sparrows Point, a so-called integrated mill, used a method of making steel that dated back to the nineteenth century. Coke and iron, the raw materials, were combined in a blast furnace to make liquid pig iron. The pig iron was poured into a vast oven, known as an open-hearth furnace, to make molten steel. The steel was poured into pots to make ingots. The ingots were cooled, reheated, and fed into a half-mile-long rolling mill and turned into semi-finished shapes, which eventually became girders for the construction industry or wafer-thin sheets for beer cans or galvanized panels for the automobile industry. Open-hearth steelmaking was expensive and time-consuming. It required great amounts of energy, water, and space. Sparrows Point stretched four miles from one end to the other. Most important, it required lots and lots of people. Sparrows Point, at its height, employed tens of thousands of them. As Mark Reutter demonstrates in

"Making Steel," his comprehensive history of Sparrows Point, it was not just a steel mill. It was a city.

In 1956, Eugene Grace, the head of Bethlehem Steel, was the country's best-paid executive. Eleven of the country's eighteen top-earning executives that year, in fact, worked for Bethlehem Steel. In 1955, when the American Iron and Steel Institute had its annual meeting, at the Waldorf-Astoria, in New York, the No. 2 at Bethlehem Steel, Arthur Homer, made a bold forecast: domestic demand for steel, he said, would increase by fifty per cent over the next fifteen years. "As someone has said, the American people are wanters," he told the audience of twelve hundred industry executives. "Their wants are going to require a great deal of steel."

But Big Steel didn't get bigger. It got smaller. Imports began to take a larger and larger share of the American steel market. The growing use of aluminum, concrete, and plastic cut deeply into the demand for steel. And the steelmaking process changed. Instead of laboriously making steel from scratch, with coke and iron ore, factories increasingly just melted

down scrap metal. The open-hearth furnace was replaced with the basic oxygen furnace, which could make the same amount of steel in about a tenth of the time. Steelmakers switched to continuous casting, which meant that you skipped the ingot phase altogether and poured your steel products directly out of the furnace. As a result, steelmakers like Bethlehem were no longer hiring young workers to replace the people who retired. They were laying people off by the thousands. But every time they laid off another employee they turned a money-making steelworker into a money-losing retiree—and their dependency ratio got a little worse. According to Reutter, Bethlehem had a hundred and sixty-four thousand workers in 1957. By the mid-to-late-nineteen-eighties, it was down to thirty-five thousand workers, and employment at Sparrows Point had fallen to seventy-nine hundred. In 2001, Bethlehem, just shy of its hundredth birthday, declared bankruptcy. It had twelve thousand active employees and ninety thousand retirees and their spouses drawing benefits. It had reached what might be a record-setting dependency ratio of 7.5 pensioners for every worker.

What happened to Bethlehem, of course, is what happened throughout American industry in the postwar period. Technology led to great advances in productivity, so that when the bulge of workers hired in the middle of the century retired and began drawing pensions, there was no one replacing them in the workforce. General Motors today makes more cars and trucks than it did in the early nineteen-sixties, but it does so with about a third of the employees. In 1962, G.M. had four hundred and sixty-four thousand U.S. employees and was paying benefits to forty thousand retirees and their spouses, for a dependency ratio of one pensioner to 11.6 employees. Last year, it had a hundred and forty-one thousand workers and paid benefits to four hundred and fifty-three thousand retirees, for a dependency ratio of 3.2 to 1.

Looking at General Motors and the old-line steel companies in demographic terms substantially changes the way we understand their problems. It is a commonplace assumption, for instance, that they were undone by overly generous union contracts. But, when dependency ratios start getting up into the 3-to-1 to 7-to-1 range, the issue is not so much what you are paying each dependent as how many

dependents you are paying. "There is this notion that there is a Cadillac being provided to all these retirees," Ron Bloom, a senior official at the United Steelworkers, says. "It's not true. The truth is seventy-five-year-old widows living on less than three hundred dollars to four hundred dollars a month. It's just that there's a lot of them."

A second common assumption is that fading industrial giants like G.M. and Bethlehem are victims of their own managerial incompetence. In various ways, they undoubtedly are. But, with respect to the staggering burden of benefit obligations, what got them in trouble isn't what they did wrong; it is what they did right. They got in trouble in the nineteen-nineties because they were around in the nineteen-fifties—and survived to pay for the retirement of the workers they hired forty years ago. They got in trouble because they innovated, and became more efficient in their use of labor.

"We are making as much steel as we made thirty years ago with twenty-five per cent of the workforce," Michael Locker, a steel-industry consultant, says. "And it is a much higher

quality of steel, too. There is simply no comparison. That change recasts the industry and it recasts the workforce. You get this enormous bulge. It's abnormal. It's not predicted, and it's not funded. Is that the fault of the steelworkers? Is that the fault of the companies?"

Here, surely, is the absurdity of a system in which individual employers are responsible for providing their own employee benefits. It penalizes companies for doing what they ought to do. General Motors, by American standards, has an old workforce: its average worker is much older than, say, the average worker at Google. That has an immediate effect: health-care costs are a linear function of age. The average cost of health insurance for an employee between the ages of thirty-five and thirty-nine is \$3,759 a year, and for someone between the ages of sixty and sixty-four it is \$7,622. This goes a long way toward explaining why G.M. has an estimated sixty-two billion dollars in health-care liabilities. The current arrangement discourages employers from hiring or retaining older workers. But don't we want companies to retain older workers—to hire on the basis of ability and not age? In fact, a system in which companies shoulder

their own benefits is ultimately a system that penalizes companies for offering any benefits at all. Many employers have simply decided to let their workers fend for themselves. Given what has so publicly and disastrously happened to companies like General Motors, can you blame them?

Or consider the continuous round of discounts and rebates that General Motors—a company that lost \$8.6 billion last year—has been offering to customers. If you bought a Chevy Tahoe this summer, G.M. would give you zero-per-cent financing, or six thousand dollars cash back. Surely, if you are losing money on every car you sell, as G.M. is, cutting car prices still further in order to boost sales doesn't make any sense. It's like the old Borscht-belt joke about the haberdasher who lost money on every hat he made but figured he'd make up the difference on volume. The economically rational thing for G.M. to do would be to restructure, and sell fewer cars at a higher profit margin—and that's what G.M. tried to do this summer, announcing plans to shutter plants and buy out the contracts of thirty-five thousand workers. But buyouts, which turn active workers into pensioners, only worsen the company's dependency ratio. Last year,

G.M. covered the costs of its four hundred and fifty-three thousand retirees and their dependents with the revenue from 4.5 million cars and trucks. How is G.M. better off covering the costs of four hundred and eighty-eight thousand dependents with the revenue from, say, 4.2 million cars and trucks? This is the impossible predicament facing the company's C.E.O., Rick Wagoner. Demographic logic requires him to sell more cars and hire more workers; financial logic requires him to sell fewer cars and hire fewer workers.

Under the circumstances, one of the great mysteries of contemporary American politics is why Wagoner isn't the nation's leading proponent of universal health care and expanded social welfare. That's the only way out of G.M.'s dilemma. But, from Wagoner's reticence on the issue, you'd think that it was still 1950, or that Wagoner believes he's the Prime Minister of Ireland. "One thing I've learned is that corporate America has got much more class solidarity than we do—meaning union people," the U.S.W.'s Ron Bloom says. "They really are afraid of getting thrown out of their country clubs, even though their objective ought

to be maximizing value for their shareholders."

David Bloom, the Harvard economist, once did a calculation in which he combined the dependency ratios of Africa and Western Europe. He found that they fit together almost perfectly; that is, Africa has plenty of young people and not a lot of older people and Western Europe has plenty of old people and not a lot of young people, and if you combine the two you have an even distribution of old and young. "It makes you think that if there is more international migration, that could smooth things out," Bloom said.

Of course, you can't take the populations of different countries and different cultures and simply merge them, no matter how much demographic sense that might make. But you can do that with companies within an economy. If the retiree obligations of Bethlehem Steel had been pooled with those of the much younger industries that supplanted steel—aluminum, say, or plastic—Bethlehem Steel might have made it. If you combined the obligations of G.M., with its four hundred and fifty-three thousand retirees, and the American manufacturing operations of

Toyota, with a mere two hundred and fifty-eight retirees, Toyota could help G.M. shoulder its burden, and thirty or forty years from now—when those G.M. retirees are dead and Toyota's now youthful workforce has turned gray—G.M. could return the favor. For that matter, if you pooled the obligations of every employer in the country, no company would go bankrupt just because it happened to employ older people, or it happened to have been around for a while, or it happened to have made the transformation from open-hearth furnaces and ingot-making to basic oxygen furnaces and continuous casting. This is what Walter Reuther and the other union heads understood more than fifty years ago: that in the free-market system it makes little sense for the burdens of insurance to be borne by one company. If the risks of providing for health care and old-age pensions are shared by all of us, then companies can succeed or fail based on what they do and not on the number of their retirees.

4.

When Bethlehem Steel filed for bankruptcy, it owed about four billion dollars to its pension plan, and had another three billion dollars in unmet health-care obligations. Two

years later, in 2003, the pension fund was terminated and handed over to the federal government's Pension Benefit Guaranty Corporation. The assets of the company—Sparrows Point and a handful of other steel mills in the Midwest—were sold to the New York-based investor Wilbur Ross.

Ross acted quickly. He set up a small trust fund to help defray Bethlehem's unmet retiree health-care costs, cut a deal with the union to streamline work rules, put in place a new 401(k) savings plan—and then started over. The new Bethlehem Steel had a dependency ratio of 0 to 1. Within about six months, it was profitable. The main problem with the American steel business wasn't the steel business, Ross showed. It was all the things that had nothing to do with the steel business.

Not long ago, Ross sat in his sparse midtown office and explained what he had learned from his rescue of Bethlehem. Ross is in his sixties, a Yale- and Harvard-educated patrician with small rectangular glasses and impeccable manners. Outside his office, by the elevator, was a large sculpture of a bull, papered over from head to hoof with stock tables.

"When we showed up to the Bethlehem board to approve the deal, they had an army of people there," Ross said. "The whole board was there, the whole senior management was there, people from Credit Suisse and Greenhill were there. They must have had about fifty or sixty people there for a deal that was already done. So my partner and I—just the two of us—show up, and they say, 'Well, we should wait for the rest of your team.' And we said, 'There is no rest of the team, there is just the two of us.' It said the whole thing right there."

Ross isn't a fan of old-style pensions, because they make it impossible to run a company efficiently. "When a company gets in trouble and restructures," he said, those underfunded pension funds "will eat it alive." And how much sense does employer-provided health insurance make? Bethlehem made promises to its employees, years ago, to give them medical insurance in exchange for their labor, and when the company ran into trouble those promises simply evaporated. "Every country against which we compete has universal health care," he said. "That means we probably face a fifteen-per-cent cost disadvantage versus foreigners for no other

reason than historical accident. . . . The randomness of our system is just not going to work."

This is what Walter Reuther believed. He went along with Wilson's scheme in 1950 because he thought that agreeing with Wilson was the surest way of getting Wilson and the other captains of industry to agree with him. "Reuther and his brain trust had a theory of capitalism," Nelson Lichtenstein, the Reuther biographer, says. "It was: If we force G.M. to pay extra, we can create an incentive for G.M. to join our side." Reuther believed, in other words, that when American corporations reached the point where they couldn't make their business more efficient without making it less profitable, when their dependency ratios soared to unimaginable heights, when they got tens of billions behind in their health-care obligations, when the cost of carrying thousands of retirees forced them to stare bankruptcy in the face, they would come around to the idea that the markets work best when the burdens of benefits are broadly shared. It has taken half a century, but the world may finally be catching up with Walter Reuther.