

# **The Defined Benefit Approach**

Edith Fierst

PRC WP 97-11  
October 1997

Pension Research Council  
3641 Locust Walk, 304 CPC  
Philadelphia, PA 19104-6218  
Tel: 215/898-7620 Fax: 215/898-0310  
Web site: [prc.wharton.upenn.edu/prc/prc.html](http://prc.wharton.upenn.edu/prc/prc.html)

This Working Paper was presented at a PRC symposium held at The Wharton School in May of 1997. Conference support was provided by the Pension Research Council, the Society of Actuaries, the Pension Section of SoA, the Population Aging Research Center at the University of Pennsylvania and The Wharton School. Opinions and conclusions are those views of the author(s) alone, and not the institutions sponsoring the conference.

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Social Security's trustees have announced that over the next 75 years there will be a shortfall of 2.17 percent of payroll. This anticipated shortfall was a primary issue before the Social Security Advisory Council of 1994-5. Other issues included the relative equity/ adequacy provided for persons at various income levels, in various family situations, and in various age cohorts. The Council was particularly invited to consider certain issues primarily affecting women, such as the increased labor force participation of women, lower marriage rates, increased likelihood of divorce and the higher poverty rates of aged women.

### **Fixing the Shortfall**

As a first order of business the Council considered the prospective shortfall. The primary reasons for it are two: People are living longer and, therefore, drawing benefits longer, and the baby boomers' children are not numerous enough to pay for their parents' benefits on a pay-as-you-go basis.

Three solutions to the shortfall were offered by different groups of the Advisory Council, only one of which fully retains its defined benefit nature. That is the proposal of the Maintain Benefits (MB) group, of which I was a member. Our proposal suggested several ways in which to fill the gap without abandoning the underlying principle that united us, namely the belief that Social Security must remain a defined benefit plan, paying promised benefits to retirees as under today's law, with only the very minimum reductions which may be needed to fill the shortfall. Above all, we agreed that the United States Government, through the Social Security trust fund, should continue to provide individuals the financial protection in old age, disability and in cases of where the breadwinner dies early, that has become its role over the last 60 years.

Our group strongly believes that the shortfall is not a good reason to scrap the assured benefits under Social Security in favor of a defined contribution plan. Others who have entered

the fray, including some who may never have favored the system in the first place, have seized the public relations cover which the shortfall provides to propose radical dismantling of the system, perhaps to satisfy their ideological bents or pocketbook interests.<sup>1</sup>

In fact, so long as the United States Government survives, nothing is more secure than U.S. government bonds.

As a member of the MB group I concur wholeheartedly with the above outline of principles. However, when it comes to the specific changes that are needed to save Social Security as a defined benefit plan, there were some differences of opinion among us. The following summary of particular steps expresses my views, rather than those of the group as a whole:

**1. Adjust the Consumer Price Index.** Most economists seem persuaded that the current CPI overstates the amount of the price increases and, therefore, leads to excessive COLA

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<sup>1</sup>1/ See, for example, the discussion by John Cassidy, in "Spooking the Boomers", The New Yorker January 13, 1997, of the views of Pete Peterson, one of the leading advocates of changing Social Security radically to a system with greatly reduced and means-tested benefits. When asked whether he hadn't exaggerated the financial problems of Social Security, he replied by citing figures that include the debts of Medicare as though they were part of the future problems of Social Security. Medicare is in serious trouble and will be out of money by 2001, but this has nothing to do with Social Security. But Mr. Peterson didn't explain this clearly. Instead he argued that the trustees were wrong in stating the Social Security shortfall as only 2.2 percent, citing a memo from two researchers for the Concord Coalition who suggested the trustee's estimate of the shortfall be treated as a "myth," and that Mr. Peterson should "make fun of the whole trust fund concept". Peterson alleges, wrongly, that the trust fund provides no security, because United States bonds, in which the trust fund surplus is now invested, are virtually worthless.

increases. This should, and undoubtedly will, be corrected. Doing so has the advantage that it would spread some of the pain of paying for the shortfall to retirees.

A major question remains whether the correction should be enacted legislatively or designed by the Bureau of Labor Statistics. Like all other members of the Advisory Council, I would prefer a technical solution by BLS, but that may take years. In the meantime, unlike most other members, I would accept a temporary political fix of perhaps 0.5 percent. This would save .74 percent of payroll, more than a quarter of the shortfall. Any reduction would be corrected up or down when BLS comes up with its technical solution.

**2. Bring new hires by State and local government employees under mandatory coverage.** Mandatory coverage of State and local employees was part of all the plans, although some Labor representatives have expressed individual doubts since many union members covered by alternative State or local plans are happy with what they now have. Bringing all of them mandatorily under Social Security coverage would save 0.22 percent of payroll, in part because the payroll tax would be paid up front, while the additional benefits would come due later on. Further, many State and local employees are now covered by Social Security through other employment; because Social Security's progressive formula tilts in favor of those with low covered earnings, the extra benefits the newly covered workers would ultimately receive would not require expenditure of all the revenue their mandated coverage would generate.<sup>2</sup>

**3. Bring the taxation of Social Security benefits in line with the taxation of other forms of pensions.** All members of the Advisory Council support the proposals to tax Social Security's defined benefits as other defined benefit pension plans are taxed and continuing to

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<sup>2</sup>The "windfall offset" which reduces the progressive tilt of Social Security for those with short covered careers combined

dedicate these tax receipts to Social Security. (Those who favor an individual account or personal savings account approach would make benefits under the defined contribution portion of their plans tax-free.)

Specifically, making Social Security taxable in the same way as other defined benefit pension plans would require (1) eliminating the current exemption of 15 percent of benefits from the income tax and substituting a tax on all benefits except money previously taxed when paid as contributions, and (2) ending the tax threshold which now exempts benefits of a single retiree with an income of less than \$25,000 and those of a married couple with an income of less than \$32,000. In all our opinions, there is no reason why retirees should receive more generous tax treatment than younger persons in the same income bracket. The living expenses of the young may include such major costs as buying a home or educating children and they have an equitable claim to equal tax treatment. Those with really low incomes are not taxed in any case since the income tax's progressive formula exempts them.

This change in tax policy would save .31 percent of payroll.

4. **Increasing the computation period.** I do not concur with the proposal of the majority of the Maintain Benefits group to increase the computation period from 35 to 38 years because doing so would have a disparate negative effect on women who spend a few years out of the labor force raising their children.

The difference in employment patterns of men and women are clear from figures provided by the Social Security actuaries. They show that 66.8 percent of male workers who retired in 1995 had 35 years of covered employment and 53.1 percent had 38 years. The comparative figures for women are 24.1 percent with 35 years and 15.4 percent with 38 years.

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with employment under other non-covered systems minimizes the

In 2029, the actuaries project that under current law there will be a very slight increase in the working years of retiring men (69.9 percent with 35 years of employment and 56.6 percent with 38 years) and much bigger increases for women (51.1 percent with 35 years of employment and 32.8 percent with 38 years).

In view of the above figures, it is no surprise that the actuaries estimate that if the computation period were to be increased by three years, women would lose more of their benefits than would men. Of those retiring in 1999, women would lose an average of three percent of their benefit compared to two percent that would be lost by men. Among those retiring in 2020, women would lose an average of 3.9 percent compared to 3 percent for men. In general women would lose 1 percent more of their benefits than would men, but some women might lose as much as 6 percent of their benefits.

The projected increase in women's working years between 1995 and 2029 is part of the continuing increase in labor force participation by women. Even so, as the figures make clear, women are expected to continue to work many fewer years than men.

The basis for the above projections is what people do and are likely to do under present law. If the computation period were increased, more workers, both men and women, might work longer periods, thus lessening the decrease in benefits they would incur. But I believe it would be unfortunate if pressure were placed on women to work extra years lest they lose retirement benefits. Young mothers should not be discouraged from choosing to stay home for child care by fear of poverty in old age. Like many other Americans, I believe the option of child care provided by the mother, especially in early childhood years, is one that families should not be penalized for choosing.

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progressive tilt for many state and local employees.

**5. Raising the normal retirement age.** The Maintain Benefits Group did not advocate raising the normal retirement age beyond the increase to age 67 enacted earlier, which will become effective in increments just after the turn of the century. The two groups favoring a shift to defined contribution plans do advocate raising it further, and in this instance, I agree with them. I believe the NRA should be raised one year, to age 68, also incrementally, and thereafter indexed to life expectancy.

My reason is that, as mentioned above, the longer and growing period of life after age 65 is a major reason for the pending shortfall. Even after the NRA rises to age 67, most individuals will still have several more years in retirement than earlier generations. If in 1935, the retirement age had been indexed to life expectancy, today the NRA would be 73. After raising the NRA, workers would still get benefits for more years than did earlier generations.

Nevertheless, it is of great concern that raising normal retirement age would be particularly hard on persons who have been employed doing physical labor. They may no longer be able to do that work in their 60's. They and other persons who are unemployed at that age will have to find alternative employment, and this may be hard. I wish I had a better solution, or knew how to help this group.

One idea I reluctantly had to abandon was to allow retirement by those who started work young, for example without college, after they completed the same number of years of work as their contemporaries who went to college and graduate school and therefore started work much later. In the ordinary case, non-college educated workers will have begun work at age 18, while their contemporaries who were still in school may not have begun until 22, or if they obtained graduate degrees, even later.

The problem in trying to use this difference in work history as a basis for allowing differing retirement ages is that Social Security does not record the working hours of covered employees, but only their earnings. Thus, it is not possible to determine from the records whether a young person who earned covered quarters did so in a summer job that paid well or from a full-time all-year job as, for example, coal miners. If we could find a way for Social Security's records to distinguish between these two types of workers (and with the subtlety to identify those who left the full-year labor market at a later time to further their educations or for other reasons, such as raising young children), we could allow the workers who had continuous full-year jobs to retire younger. But to date, we can't.

5. **Set a cap on tax-free contributions to health benefit plans.** Newly subjecting a portion of the premiums paid by employers toward their employees' health benefits to the Social Security payroll tax would raise considerable money and do so fairly and without undue pain. The Social Security actuaries estimate that if all health benefit premiums paid by employers in excess of \$300 a month were subject to the Social Security payroll tax, Social Security would net 0.6 of payroll, after taking into consideration the cost of additional benefits payable to retirees based on this extra compensation. These extra tax receipts would be enough to reduce the anticipated shortfall over the next 75 years by about 25 percent, from 2.17 percent of payroll to 1.57.

The idea to cap tax-free contributions to health benefit plans, although not recommended by the recent Social Security Advisory Council, is not mine alone. For example, capping them at \$410 a month was suggested by Pete Peterson in his report for the Entitlement Commission. Other well-known economists, including Martin Feldstein of Harvard and Eugene Steuerle of the Urban Institute, also favor this type of approach.



Today's exemption from the payroll tax of all health insurance premiums is extremely unjust to the 30 percent of employees whose employers don't provide them health insurance. (So is the current exemption from the income tax of most of this compensation, but that is a separate matter, not directly Social Security's concern or that of this paper.) It provides recipients of employer-funded health insurance a subsidy at the expense of the taxpayers; the fortunate ones never pay a tax, payroll or income, on employer funds used for their health insurance. By contrast, workers without fringes who want health insurance must purchase it with after-tax money. Unfortunately, many uncovered workers cannot afford to buy these additional benefits with their remaining income.

The exempt percentage of earned income in the form of fringe benefits, including pensions, life insurance and other non-cash compensation, gets larger each year as employers increase the proportion of non-cash compensation. This trend is expected to continue. According to the Social Security trustees, the exempt amount for fringes generally is growing by 0.2 percent per annum, and is expected to keep doing so, thus creating some of the anticipated Social Security shortfall.

Assessing the payroll tax on a portion of employer-paid health benefit premiums is unlikely to discourage employers from continuing to pay the premiums as they could still deduct their expenses from the income tax. Taxed employees would still have a major advantage over those employees without any employer-provided health insurance.

Some of those against assessing the payroll tax on health benefits argue that it would fall most heavily on older, less healthy employees for whom health benefits are the most expensive; even when this is true -- and it need not be if employers were allowed to allocate the cost for tax

purposes among their employees in any reasonable way-- the cost to that group would be no greater than that on employees who are not covered by employer-funded health insurance.

**6. Provide for the trust fund to invest in private equities.** Until recently Social Security has been a pay-as-you-go system, with very little build-up of resources. In recent years, however, with so many baby boomers in the labor force, a surplus has been accumulating. The vastly increased participation of married women in the labor force has added to the surplus since under the dual entitlement rule, discussed below, contributions of married women are not repaid in full as benefits.

The excess in the trust fund over what is needed to pay current benefits is presently invested in government bonds which generate income averaging 2.3 percent per annum after inflation. Government bonds are as secure as any investment could be, but on average and over time they earn less than do equities, which bring in an average of 7 percent after inflation, even when the market does not display the "irrational exuberance," in Alan Greenspan's colorful phrase, which has characterized much of the 1990's. Thus, in the future, the MB group suggests we consider allowing the trust fund to invest in the stock market.

Permitting investment of some of the surplus in private markets would diversify Social Security's trust fund as ERISA (the Employee Retirement Income Security Act) requires private defined benefit pension plans to diversify their investments. Such diversity is deemed prudent for private plans and would be for Social Security.

Under the Maintain Benefits plan of the Advisory Council, investments would be made in indexed funds, such as Standard & Poor's 500 or the Wilshire 5,000. Moreover, the total investment by Social Security would not exceed 10 percent of equities in the market, preventing it from distorting values in the market.

If all investment were through indexed funds, no government representative could pick and choose among individual companies. This obviates the concern that Congress would prohibit investment in tobacco stocks or insist on some other form of social investing.

Participation in corporate governance would be mandated to be the same as that of the other owners who vote securities in the particular company, precluding the Government from influencing corporate boards.

**7. Do not increase the payroll tax.** Unlike other members of the Advisory Council, I do not favor increasing the payroll tax rate even slightly above its current level of 12.4 percent (half on employers and half on employees). The MB group would increase taxes the least, by 3 to 4.5 percent in the long run. Such an increase would not be necessary if the modifications to the Maintain Benefit plan outlined above were adopted.

The defined contribution plans suggested by the other two groups of the Council, would require increases respectively of 1.52 percent of payroll for 70 years, or 1.60 percent of payroll permanently.

#### Problems with a Defined Contribution Approach

Investment by the trust fund is very different from privatization which puts individuals at risk when a major portion of their Social Security contributions in the stock market as they determine. Under privatization, the burden of failure of the market would be on the individual, rather than on the system. Since no one can be sure of the fate of any particular investment, especially at the moment when he or she wants to retire, putting the risk of the failure of an investment on an individual would undercut the security offered by Social Security.

Several examples of the disaster that could await individual investors if the risk of poor investments were on them were provided in an article published March 9, 1997, on page 7 of the

News of the Week section of the New York Times. The article concerned the fate of Steven Hoffenberg, a financier who was convicted of defrauding investors through a company called Towers Financial Corporation. The Times published excerpts from several letters Hoffenberg's victims had written to the judge, hoping to persuade him to give the defendant a long sentence. (The judge did -- 20 years)

Some of those excerpts are worth considering:

Anthony Mattas of Hanford, CA wrote:

I was employed by Armstrong Tire Company for 24 years... When I retired I was a maintenance foreman. During my employment with Armstrong, I contributed up to 17 percent of my salary to a retirement fund. When I retired... [I rolled over] \$116,843.49 into an I.R.A., and \$43,000 in another account with Towers Financial.

I sacrificed a big portion of my wages so I would have something when I retired. My current financial condition is that I will have to continue to work in order to exist...

RoseAnn Marchu of Vista, CA wrote:

I am 69 years old. My husband, John is 75... We have worked hard all our lives, hoping to have a half-way comfortable retirement. Now with the loss of money that was stolen from us by this person...,I have to watch every penny. My husband has had many strokes, which have left him legally blind... I cannot afford to send him to day care therapy more than one day a week.

Eloise Eaton of Parker, AZ, wrote:

Financial promissory notes. At first I resisted. [Eventually I invested \$213,000.] I figured that \$213,000 at 14 percent should bring me in around \$2,485 a month.

At the time I invested in the promissory note, I was under a great deal of stress. My husband was seriously ill with Alzheimer's disease and major depression in a nursing center. His care was around \$3,000 a month... My goal was to have a safe investment to help pay for his care and also take care of myself in the future. The bankruptcy court returned only \$1,102 of my \$213,000 investment.

Catastrophes to the individuals quoted above were all the consequence of a scam. It is not

the only one in recent times.<sup>3</sup> But there are plenty of other ways of losing a fortune, not all of them due to criminal activity. It does not take much imagination to conjure up disaster occurring because a company in which an individual had invested heavily went into bankruptcy, or because of a general market collapse. The market did not recover from the crash of 1929 until several years after the Second World War, nor did it recover from the drop in the value of securities from their 1972 level following the 48 percent decline between 1973 and 1974 for nearly a decade.

It is not sufficient comfort that the market did ultimately recover and surpass its earlier levels. Anyone retiring in the interim and relying on the value of his or her stocks would have been in serious trouble. Many people, particularly if they planned to annuitize their accounts (see

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<sup>3</sup> / Other recent scams led to the collapse of Comparator Systems, Centennial Technologies, and Bre--X Minerals, all fraudulent billion dollar companies, came to disaster, as reported on page 1 of the New York Times Business section for March 30, 1997.

discussion below), could not retire when they hoped, and might have to wait in uncertainty for years. This would put unnecessary tension in the lives of those reaching retirement age.

Very few non-professional are able to invest knowledgeably in the stock market. All sorts of factors unknown to the lay person affect the value of a stock, e.g. the competence of management, the accounting system used, technology, overseas competition, and other similar factors. Professionals are available, but naturally they charge for their advice. A consultant to the Advisory Council, whose analysis was accepted by all members, estimated that private investors would have to pay 100 times the amount it would cost the trust fund to pay for investment services. And small accounts would have to pay proportionately more for work than would large.

Altogether this means the returns from individual investments would be uncertain, and those at the low end of the income spectrum would get less, both absolutely and proportionately, than their more well-to-do colleagues, thereby erasing the progressive tilt of current law Social Security. Clearly leaving the investments to the trust fund would be much better for many people.

Since Social Security is virtually the only retirement income of half of all Americans, the promise of assured benefits is of critical importance. Under the Maintain Benefits plan modified as I suggest, benefits would remain about the same, except for the effect of increasing the normal retirement age, which are ultimately made up by longer periods of drawing benefits. Under the plan of the Advisory Council group which favored the most radical plan, the Personal Savings Account plan (PSA), the assured benefit would be \$410 a month, plus for married couples, a spouse benefit of \$205 or, if proposed changes described below are made, \$136 a month. Under the Individual Account plan (IA) offered by the third group on the Council as a compromise version, the benefit would be computed as under present law, but under a different formula which, together with an increase in the computation period, would cause a decrease of about 10 percent

in the defined benefit of minimum wage workers (plus the effects of raising the normal retirement age). Workers with higher earnings would lose more of their benefits from a change in the formula. The average decrease in benefits under this plan would be 30 percent, of which 6.7 percent would be for raising the normal retirement age one year.

Under a third plan offered by William Shipman, Co-chair of the Cato Institute's Project on Social Security, for those workers who shift to a defined contribution plan, there would be a minimum guarantee of benefits equal to 42 percent of pre-retirement earnings, the percentage now payable to average steady workers. This is 14 percent less than the 56 percent payable under current law to the low-paid, and 14 percent higher than the 28 percent payable under current law to the high paid workers.

None of these plans would provide individuals the security of today's law.

Privatization would be bad for women Even though today's women are employed far more than were previous generations, they are still in need of survivor benefits. This is because under the dual entitlement rule, survivor benefits are the higher of the benefit earned by either the worker or the spouse and most women continue to earn less than their husband do. Little change in this pattern is expected. Among those retiring in 2015 only 20 percent are expected to have higher earnings records than their husbands. Therefore, most women will continue to want survivor benefits.

Some will also want with spouse benefits, payable while both husband and wife are alive. Under the dual entitlement rule spouse benefits are payable to women who earn benefits which are less than half those earned by their husbands. <sup>5/</sup> Because most women today are working and earning benefits exceeding half their husband's benefits, the numbers in need of spouse benefits are diminishing, but they will not vanish.

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4/ See 1996 Trustees Report, at page 184.

5/ Since Social Security is gender neutral, spouse and survivor benefits are payable to a husband when he was the lower earner in the same way as they are to a wife who was the lower earner.



Another advantage for women of current Social Security over a defined contribution plan is that under it spouse and survivor benefits are payable without any reduction in the benefits their husbands receive. These benefits are payable as a matter of law, including to those divorced after marriages of at least 10 years duration. Knowing this gives great peace of mind to both men and women as they look into the future. It has provided a basic minimum income for elderly widows and enabled them to live independently of their children and with self-respect.

Under the proposal for privatization, the promise of benefits would disappear. The PSA plan would provide for the privatized portion to go entirely the one who earned it. Similarly under the IA plan, all of the benefits would go to the worker during his lifetime; after his death the widow would be entitled to an annuity equal to half his benefit unless she waived it.

If a payment is to be made to a spouse or survivor, it must come from the pocket of the one who earned it. This includes survivor benefits under the IA plan, which would be would be paid for by an actuarial decrease in the worker's benefit during his lifetime.

Making the worker pay for the spouse's benefit would newly give him (or her) incentive to fight against payment of benefits to the other, thus destroying the comfort now provided by Social Security to both parties.

Some couples might decide to divorce in order to assure an equitable division of benefits since divorce courts generally will not divide the assets of a couple in an intact marriage. However, when the court makes a division, it divides only those assets or benefits earned during marriage. Therefore, privatization could be a major incentive for marriages to dissolve, but would not provide women the complete protection they get under today's law.

The wife's situation might erupt as an emergency. If she does not act before her husband reaches age 65 and gets access to his personal account, it might be too late. Unlike current Social Security, which pays benefits every month for life, most of the privatization plans -- except for IA which does include annuitization -- make the individual account unrestrictedly available to the beneficiary. He has complete freedom to spend it as he wishes. A likely first use would be to pay debts. Some retirees might take the remainder and splurge.

Probably most would try to spread it over a lifetime but without an annuity policy, they will have difficulty doing so. For one thing, few people realize that at age 65 men have a life expectancy of 15.3 years (to over age 80) and women of 19.1 years (to over age 84). The family money must also be stretched to cover the age difference between husband and wife, in the typical case, three years.

The above figures are averages only. Some retirees will die younger, but others will live longer.

As indicated above, the only sure way to provide lifetime income is through an annuity which pays benefits every month for life. Social Security does this, and goes one step further, adding a cost of living supplement. It promises that the income payable to a beneficiary at age 65 will continue for the rest of his or her life (or increase in widowhood) and will keep its purchasing power. Nothing similar is available in the private market.

If we abandon Social Security in favor of privatization, we must expect that many people will outlive their incomes; certainly their wives will. Some who otherwise face destitution will seek SSI (welfare for the elderly), which the rest of us pay for through the income tax.

Changes to make Social Security better for widows. Social Security has eliminated poverty for all but about 12 percent of today's elderly. A high proportion of the remaining poor

are elderly widows. Something should and can be done to improve their situation without incurring excessive costs.

The proposal supported by both the PSA and IA groups, but not by other members of the Maintain Benefits group who balk at any increased cost, is to raise the benefits of survivors from today's level (the higher of their own earned benefit or that of their husbands) to 75 percent of the combined benefit of both. This would help survivors of two-earner couples where both earned benefits that could be added together before determining their survivor benefit. The survivors of one-earner couples would not receive higher benefits as a result of this change.

Raising benefits for the survivor of two-earner couples is fair since they have paid greater taxes for which the dual entitlement rule has prevented their getting full returns.

Part of the cost of this improvement could be paid for by reducing spouse benefit from their current level of one-half the higher earner's benefits to one-third. Most women would be unaffected by this change because most earn benefits that exceed those of their husbands. Many of those who have not earned as much as half of their husband's benefits have earned benefits which would cushion any reduction in their spouse benefits.

The poverty rate of elderly couples would not increase greatly as relatively few married couples are poor or near poor. The divorced who did not earn substantial benefits would be the hardest hit if they have no one to share their living expenses.

Some who advocate this type of change would reduce spouse benefits to 25 percent of the high earner's benefits in order to avoid any cost from increasing survivor benefits, but I would not. A cut in spouse benefit from half to 25 percent would be too large a reduction for some individuals.

## CONCLUSION

I am not opposed to individuals investing in the stock market and might even be receptive to a proposal -- such as that made nearly 20 years ago by the President's Commission on Pension Policy, to require individuals to make their own investments -- so long as these are in addition to and not instead of regular Social Security benefits. The important principle is to retain Social Security as the first leg of the three-legged stool. If benefits are cut, the first leg won't be able to bear its weight.