

# **Comparing Automotive and Steel Industry Legacy Cost Issues**

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## Summary

The October 2005 bankruptcy filing by Delphi Corporation is reportedly the largest ever in manufacturing and, as Delphi is the largest U.S. automotive parts supplier, it has been a jolt to the whole industry. Concern is also growing over the increasing costs and competitive impact of pension and health care benefits paid by the U.S.-origin manufacturers of motor vehicles, the “Big Three” of General Motors (GM), Ford, and the Chrysler Group of DaimlerChrysler. The recent experience of the steel industry with respect to pension and health care legacy costs may influence the ongoing developments in the automotive sector.

Consolidation of the American steel industry occurred during and after the period of presidentially determined safeguard relief from import competition, in 2002-03. It involved the shedding of pension and health care liabilities, particularly on the integrated side of the industry. But while the domestic steel industry, including the integrated steel mills, the United Steelworkers union (USWA), and the largely non-union steel minimills, all supported trade relief, they were divided among themselves on legacy cost issues. These divisions within the industry prevented it from developing an agreed position on legacy cost legislation. Consequently, when many steel mills went bankrupt, pensioners and workers lost company-paid health care and pension benefits, except to the degree that the latter were covered by the Pension Benefit Guaranty Corporation (PBGC). The health care premiums of some retirees have also been partly paid through a provision of the Trade Act of 2002 (P.L. 107-210).

The Big Three do not face as high a ratio of retirees to active workers as the steel industry, but they find themselves supporting a large number of retirees and health care beneficiaries, because of benefits established and enhanced through several decades of collective bargaining. Unlike the steel industry, total automotive manufacturing employment in the United States today is about the same as in 1990, not in steady decline. However, much of the gain in employment has been at internationally owned assembly plants and their suppliers, generally non-union, and frequently outside the Midwest “auto belt,” while the Big Three have downsized employment by 600,000 jobs in North America since the early 1980s. Unless all sides of the industry, including the Big Three, the international competitors, and the industry’s unions, can agree on a plan to deal with legacy costs, the impact of industry changes for retirees and health care beneficiaries could be determined once again in the bankruptcy courts.

Thus, legacy costs are again a major issue faced by Congress. Legislation in the 109<sup>th</sup> Congress includes bills to reform PBGC, particularly H.R. 2830 and S. 1783; to seek reduced costs through use of information technology (as in S. 1418); and, to allow persons not eligible for Medicare to “buy in” to the program (as proposed in H.R. 2072). S. 2045, introduced on November 17, 2005, proposes federal payment of 10% of a domestic automotive manufacturer’s retiree health care costs, in exchange for increased investment in producing fuel-efficient vehicles. This report will not be updated.



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# Comparing Automotive and Steel Industry Legacy Cost Issues

## Introduction

Many congressional offices have expressed concerns regarding the recent bankruptcy filing by Delphi Corporation, a major automotive parts supplier, especially regarding the impact on retirees. Adding to these concerns are the continuing high costs and competitive impact of pension and health care benefits paid by the three large U.S.-origin manufacturers of motor vehicles, the “Big Three” of General Motors (GM), Ford, and the Chrysler Group of DaimlerChrysler.

The recent experience of the steel industry with respect to pension and health care legacy costs may influence the ongoing developments in the automotive sector. “Legacy costs” is the common term for worker pension and health care benefits that were negotiated in past collective bargaining agreements. The issue of legacy costs was a major factor in the restructuring of the U.S. steel industry.<sup>1</sup> The automotive industry is the largest sectoral customer of the steel industry in North America. One commentator has suggested, for example, “... as [the major unionized automotive manufacturers] take aim at ‘legacy costs’ ... [t]he gyrations of the steel industry provide a road map of how they might reconfigure their industrial relations”<sup>2</sup>

## The Automotive Industry Seeks to Reduce Legacy Costs

The largest U.S.-based automotive parts manufacturer, Delphi Corporation, on October 8, 2005, filed for reorganization under Chapter 11 of the U.S. bankruptcy code. Delphi was spun off from General Motors (GM) in 1999. It includes a wide range of parts-making operations in the United States and abroad, although the foreign units are not included in the bankruptcy filing. The U.S. operations of Delphi, whose employment base includes about 33,000 unionized hourly workers, are included in the bankruptcy filing. Robert S. (“Steve”) Miller, the newly appointed CEO of Delphi, has stated that the package of pay and benefits for

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<sup>1</sup> For a summary, see CRS Report RL31748, *The American Steel Industry: A Changing Profile*, by Stephen Cooney, pp. 25-29.

<sup>2</sup> Eduardo Porter, “Reinventing the Mill: Can Steel Makers Provide a Road Map for Other Ailing Industry Giants?” *New York Times* (Oct. 2, 2005).

unionized production employees, which he calculates as worth about \$65 per hour, cannot be maintained if the company is to remain competitive.<sup>3</sup>

On October 17, 2005, GM announced that it had reached an agreement in principle with the United Auto Workers union (UAW) to reduce its health care bill by about \$1 billion annually. Under the deal, workers and retirees, who are receiving health care benefits from the company as negotiated in contract bargaining, would henceforth pay a larger share, capped at about \$750 per year, of their health care costs. Current employees also will give up a \$1-per-hour wage increase agreed for 2006 (about \$2,000 annually per worker) to help fund the company health care program.<sup>4</sup> The agreement has been ratified by a 61% affirmative vote of current active UAW workers, an endorsement considered “tepid” by some observers.<sup>5</sup> At the same time, GM announced a cumulative annual loss of \$4.2 billion for the first three quarters of 2005 in its North American automotive operations.

A few months earlier, Visteon Corporation, the parts-making operation that Ford Motor Company had spun off in 2000, reached agreement with Ford for the former parent to take back about half of Visteon’s U.S. plants and almost all of its 18,000 UAW-organized workers. Visteon, which had been the second-largest U.S.-based auto parts manufacturing operation, has become a much smaller company, with most of its industrial labor outside the United States. Ford has announced that it intends to sell or close the two dozen Visteon plants that it has reacquired.<sup>6</sup> Like GM, Ford is losing money and market share in its North American automotive operations. Chrysler was profitable in 2005, but also has high legacy costs. Under the industry practice of “pattern bargaining,” both Chrysler and Ford are seeking health care cost adjustments similar to those at GM in their labor contracts.<sup>7</sup>

Over the course of the past two years, a number of other automotive parts manufacturing companies also have entered Chapter 11 bankruptcy, including union-organized plants. Many of these companies have been squeezed between rising prices for raw materials (especially steel and plastic resins), continuing pressure from Big Three customers on product price, and declining demand as Ford and GM have

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<sup>3</sup> Delphi Corp., “Delphi Corp. Files Voluntary Ch. 11 Business Reorganization Cases to Execute Transformation Plan and Address Legacy Issues and High-Cost Structure in the U.S.,” news release (Oct. 8, 2005), pp. 2-3.

<sup>4</sup> *Wall St. Journal*, “GM, Amid Industry Overhaul, Cuts Health Benefits for Retirees” (Oct. 18, 2005), p. A1; *Washington Post*, “GM’s UAW Retirees Face Health Care Costs” (Oct. 21, 2005), p. D1; *Detroit News*, “Black October: How One Month Changed the Course of the Auto Industry,” pt. 2 (Nov. 13, 2005).

<sup>5</sup> *Detroit Free Press*, “UAW Grants Tepid Support to Sharing GM Health Costs;” and, *Detroit News*, “GM Workers to Agree to Pay More Toward Health Care” (Nov. 12, 2005).

<sup>6</sup> *Automotive News*, “Ford Studies Chrysler’s Operation Divestitures” (Oct. 10, 2005), p. 18; and, “Visteon Seeks Lower Wages by Moving Jobs Out of U.S.” (Oct. 17, 2005), p. 16. The latter article calculates that “Visteon’s average North American wage and benefit structure went from \$38 to \$17.”

<sup>7</sup> *Detroit Free Press*, “UAW, Ford Discuss Health Care” (Nov. 17, 2005); *Detroit News*, “UAW, Chrysler to Start Talks Over Health Care” (Nov. 23, 2005).

lost market shares and cut back production. Delphi, with \$28 billion in annual sales in 2004 (and only just overtaken by Bosch as the world's largest automotive parts supplier) ranks as the largest bankruptcy of a manufacturing company in history.<sup>8</sup> But besides Delphi, major auto parts companies that have entered Chapter 11 reorganization in recent years include Collins & Aikman (\$3.9 billion in 2004 sales), Federal-Mogul (\$3.4 billion), Tower Automotive (\$3.2 billion), and Oxford Automotive, a major U.S.-based supplier, which since has been broken up.<sup>9</sup>

**Table 1: Automotive Parts Industry Plants and Employment**  
(NAICS 3363, 2004 data)

	Plants	Employees		Plants	Employees
Alabama	123	13,042	Montana	13	98
Alaska	1	ND	Nebraska	35	4,458
Arizona	83	3,387	Nevada	32	775
Arkansas	68	7,150	New Hampshire	15	1,272
California	692	21,248	New Jersey	66	1,582
Colorado	72	1,263	New Mexico	16	90
Connecticut	59	5,060	New York	218	25,466
Delaware	12	611	North Carolina	167	18,215
Florida	179	5,819	North Dakota	19	862
Georgia	172	11,372	Ohio	578	94,075
Hawaii	4	ND	Oklahoma	78	4,819
Idaho	11	298	Oregon	78	2,241
Illinois	307	29,113	Pennsylvania	139	9,885
Indiana	375	77,405	Rhode Island	9	ND
Iowa	69	9,443	South Carolina	110	18,887
Kansas	45	3,593	South Dakota	14	673
Kentucky	170	30,962	Tennessee	223	36,660
Louisiana	39	1,429	Texas	316	15,488
Maine	11	493	Utah	51	5,413
Maryland	40	2,165	Vermont	10	ND
Massachusetts	37	1,747	Virginia	93	8,819
Michigan	1,032	168,955	Washington	87	2,255
Minnesota	93	3,165	West Virginia	12	2,164
Mississippi	88	7,331	Wisconsin	120	13,456
Missouri	188	16,862	Wyoming	11	93
			<b>U.S. TOTAL*</b>	<b>6,476</b>	<b>690,527</b>

ND: Non-disclosable, because of data inadequacy or company confidentiality.

\*U.S. totals may not equal sum of state totals due to non-disclosable data, data not attributed to specific states, and rounding in calculating annual average total.

**Source:** Department of Labor. Bureau of Labor Statistics. "Quarterly Census of Employment and Wages."

<sup>8</sup> *Detroit Free Press*, "Labor Costs Sink Delphi" (Nov. 10, 2005).

<sup>9</sup> A description of the U.S. automotive supplier industry and its competitive situation is in CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, pp. 78-83 and Table 6.

To indicate the major impact of parts suppliers on the national and local economies, **Table 1** lists the number of automotive parts plants and total employment for each state.

Some Members of Congress have become increasingly concerned that these developments presage termination by the domestic motor vehicle manufacturing industry of responsibilities for legacy costs under collective bargaining agreements. A number of commentators have drawn attention to parallels with industries such as airlines and steel, particularly the latter, in which management has used the bankruptcy process in order to shed legacy costs, and to force unions to accept streamlined and downsized workforces.<sup>10</sup> Pension liabilities that were formerly the responsibility of these private sector companies have been taken over by the Pension Benefit Guaranty Corporation (PBGC), an entity chartered by Congress that insures qualifying private sector pension funds. PBGC calculates that as of the end of its 2005 fiscal year, its net deficit of liabilities over assets was approximately \$23 billion, and that the total underfunding of all insured private sector pension plans was \$450 billion.<sup>11</sup> Moreover, the maximum pension benefits insured by PBGC are frequently less generous than the benefits guaranteed in the corporate plans that PBGC takes over. From the retirees' point of view, that is still better than the case for private health care plans, for which there is no similar federal guarantee. Plan participants have essentially lost such coverage in bankruptcies, though they may receive assistance if their coverage is from prefunded health care plans (see below).

Retirees may also qualify for partial federal reimbursement of coverage under a qualified plan through the tax code.<sup>12</sup>

## Comparing Steel and Automotive Legacy Costs

The ratio of retirees to active workers was much higher in the steel industry at the peak of its financial distress after 2000 than it is in the automotive industry today, in terms of numbers of individuals affected by loss of or changes in coverage caused by companies' economic circumstances. The bankruptcies of three of the largest integrated U.S. steelmaking companies (Bethlehem, LTV and National Steel) in 2001-03 led to the loss of corporate pensions and health care coverage of about

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<sup>10</sup> For example, see Mark Reutter, "Workplace Tremors," *Washington Post* (Oct. 23, 2005), p. B1. Steve Miller himself, then-CEO of Bethlehem Steel, took that company into bankruptcy, through which it shed its retiree pensions in the largest single PBGC takeover of a steel industry plan. Miller has stressed, however, that no decision will be made by the company as to whether Delphi will terminate its pension plans for at least a few months; *Wall St. Journal*, "Reassembling Delphi" (Oct. 17, 2005), p. B1.

<sup>11</sup> PBGC. "PBGC Releases Fiscal year 2005 Financial Results," press release 06-06 (Nov. 15, 2005).

<sup>12</sup> Details of the health care assistance for recipients of pensions from PBGC are in CRS Report RL31593, *Health Insurance for Displaced Workers*, by Julie Stone et al; and CRS Report RL32620, *Health Coverage Tax Credit Authorized by the Trade Act*, by Julie Stone and Bob Lyke. S. 329 has been introduced in the 109<sup>th</sup> Congress by Sens. Rockefeller and Leahy to provide all retiree beneficiaries with health care coverage with a secured claim under chapter 11 of the bankruptcy code.

200,000 retirees, compared to about 30,000 active employees at those three companies. Leo Gerard, president of the United Steelworkers union, estimated that a total of about 600,000 retirees received retiree benefits and health care through contracts reached in collective bargaining agreements in the steel industry. By comparison, after declining by 50,000 over ten years, the total number of steelworkers at integrated works and minimills was less than 125,000 in 2002.<sup>13</sup>

The automotive industry as a whole has not seen such a decline in employment. Total employment in the industry, including the manufacture of parts and components, was more than one million in 1990, and was still more than a million in 2004. However, the structure of that employment has changed. The “de-integration” of the traditional Big Three automotive manufacturers (GM, Ford and Chrysler) meant that those companies shed more than 600,000 jobs after 1980. Some of those jobs were transferred to GM and Ford’s spun-off parts makers, principally Delphi and Visteon.<sup>14</sup>

As a consequence of this reduction of direct employment by the Big Three, they are moving in the same direction as the steel industry. They now provide pension and health care benefits determined by defined benefit contracts negotiated through collective bargaining and support a base of retirees and dependents that outnumbers the remaining active employees. GM by 2004 employed less than 180,000 in its U.S. automotive operations; Ford about 110,000; and, the Chrysler Group about 80,000 — a total of 370,000 active Big Three employees. The Automotive Trade Policy Council (ATPC), a joint Big Three representative organization, calculated in 2004 that its members supported more than 800,000 retirees. Thus, the total potential claims of automotive industry pension funds on PBGC would be much greater than all the liabilities PBGC has assumed to date.

ATPC also calculated that its member companies spent approximately \$10 billion annually on employee and retiree health care, more than half of that by GM alone. In a widely publicized statement, GM CEO G. Richard Wagoner has noted that each of his company’s vehicles produced in North America includes an average cost of \$1,525 in health care benefits, and asserted that GM is the world’s largest private provider of health care benefits.<sup>15</sup>

Delphi has a lower ratio of active employees to retirees than its former parent. According to information from PBGC, 75,000 Delphi employees are in PBGC-insured pension funds, including 13,000 retirees who have retired from Delphi since

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<sup>13</sup> CRS Report RL31748, *The American Steel Industry: A Changing Profile*, by Stephen Cooney, pp. 25-27.

<sup>14</sup> Employment trends in the U.S. automotive industry are discussed in detail in CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, pp. 14-17.

<sup>15</sup> The data in the preceding paragraphs are reported in CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, pp. 30-31, 44; the statistic from Richard Wagoner was initially quoted in “Health Care Costs Burden GM by \$4 Billion, CEO Says,” *Detroit Free Press* (Feb. 11, 2005).

it was created in 2000. PBGC has calculated the estimated “termination liability” of the Delphi pension plan. Total liability would be \$10.8 billion, of which \$4.1 billion would be the amount covered by PBGC.<sup>16</sup> The responsibility for the balance, per agreement between GM and the unions when Delphi was established, may revert to GM, thus adding to GM’s own overall pension liability. This amount could include some responsibility for Delphi retirees’ health care, currently and in the future.<sup>17</sup> Although GM is not bankrupt and still has a strong cash balance position despite recent losses, these responsibilities would add to its already considerable legacy cost burden.

Delphi’s ability to bear the burden of high and ongoing legacy costs has been considered by the company to be a key competitiveness issue from its very beginning. For example, a recent *Automotive News* article quotes from Delphi’s original prospectus of 1999:

A substantial portion of our cash flows from operations will be dedicated to meet our pension funding obligations ... As a result of these [and certain other] obligations, our liquidity position may be adversely affected if we fail to meet our expected cash flow from operations.

While such disclaimers might be considered as routine in a corporate prospectus, the article goes on to note that in this case it proved “prophetic.” In a press conference on the bankruptcy filing, CEO Miller emphasized declining revenue from its former parent GM’s declining light vehicle market share and production volumes. He concluded:

The impact on Delphi has been to reduce revenues by several billion dollars a year worth of parts. Given our high fixed costs and inflexible labor costs, the result has been devastating.<sup>18</sup>

Thus, while the number of retirees directly affected in the Delphi filing does not approach the levels seen in the steel industry bankruptcies after 2000, how legacy cost issues for retirees and continuing employees are to be resolved is important both in the development of a bankruptcy reorganization plan — either through collective bargaining or through the judicial process. Furthermore, legacy costs affecting both retirees and current employees will likely be an issue for the Big Three automotive companies, particularly Ford and GM, arising from the former parts-making affiliates’ pension and health care plans. In this respect, there are parallels between the steel and automotive industries.

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<sup>16</sup> Data from CRS interviews with PBGC Deputy Director Vincent Snowbarger (Oct. 19-20, 2005), confirming liability estimates reported in “Bill to Boost U.S. Pension Agency Meets Resistance by Businesses,” *Wall St. Journal* (Oct. 17, 2005), p. A2.

<sup>17</sup> The shares of pension liability attributable to PBGC, GM and Delphi, in case of a potential termination of the Delphi pension plan, and the conditions under which GM retains liability for beneficiaries, are complex subjects and are still subject to litigation. See for example, “Delphi’s Miller Rethinks Divisive Rhetoric,” *Detroit News Auto Insider* (Oct. 28, 2005).

<sup>18</sup> Quotations from Richard Truett, “Delphi’s First Prospectus Foreshadowed Problems,” *Automotive News* (Oct. 24, 2005), p. 17.

## Competitive Splits in the Automotive and Steel Sectors

Both the steel industry and the automotive industries in the United States are bifurcated in a manner that indicates sharply different perspectives on legacy cost issues. The nature and sources of the bifurcation are different in the two cases, however. The U.S. steel industry is divided between integrated steel mills, which produce steel from iron ore and other inputs in basic oxygen furnaces, and minimills, which produce steel primarily from remelted ferrous scrap in electric arc furnaces. Each of the different technological sides of the industry presently produce about half of the total U.S. annual production of about 110 million tons of steel output each year. The minimills have been gaining share, however, and after 2000 overtook the older integrated side of the industry as the main domestic producer of steel.

The minimills, led by Nucor, by far the largest of the minimill producers, tend to be non-union operations, mostly located in states or regions that are not traditional steel-producing areas, such as Arkansas and South Carolina. The integrated mills today are concentrated in the Great Lakes region, particularly northwest Indiana, and maintain production in Ohio, Pennsylvania, Michigan, Maryland, West Virginia and downstate Illinois, across from St. Louis. Since Utah's Geneva Steel shut down in 2002, no integrated steel mills are located west of the Mississippi River. All of the integrated mills are organized by unions, primarily the United Steelworkers (USWA).<sup>19</sup>

This split parallels that in the automotive industry between the traditional Big Three assembly plant operators, which in the 1950s produced virtually all of the volume car production in the United States, and the internationally based operators, which began building plants in the United States, after U.S. political and diplomatic pressure led Japanese companies to begin doing so in the early 1980s.<sup>20</sup> The Big Three assembly plants, and concomitantly their affiliated and unaffiliated supplier operations, not coincidentally are concentrated in the same part of the country as the integrated steel mills, a so-called "auto belt" of midwestern states around the Great Lakes. All Big Three assembly plants, spun-off and formerly affiliated supplier operations, and many independent parts plants in this region are represented by organized labor.

By contrast, the major Japanese-owned manufacturers, later joined by German and Korean companies, have opened their U.S. assembly plants in the South, with the notable exceptions of two Honda assembly plants in Ohio, a Toyota plant in

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<sup>19</sup> CRS Report RL31748, *The American Steel Industry: A Changing Profile*, by Stephen Cooney, pp. 8-16.

<sup>20</sup> In the 1970s Volkswagen was the first foreign-owned company to begin volume production in the United States, but has since closed its U.S. manufacturing operation. Honda also started manufacturing motorcycles here in 1979, before it later began producing cars at the same location in Ohio. On the establishment of the so-called "transplants," see CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, esp. pp. 54-56.

southwest Indiana, and an early Toyota-GM joint venture plant in California. Virtually none of the internationally owned assembly plants are union-organized.<sup>21</sup> Many of their suppliers are also foreign investors in the United States. Some are affiliated companies that have invested in the United States, such as Denso and Aisin Seiki, both controlled by Toyota and part of its *keiretsu*. Others are independent companies (such as Robert Bosch, Faurecia and Siemens VDO). Many of these operations are also southern-based and non-union.<sup>22</sup>

The preference by foreign companies for locations outside the traditional auto belt is shifting the geographical focus of the auto parts industry. While noting that it remains centered in the Midwest, economist Thomas Klier of the Federal Reserve Bank of Chicago calculates that the location of new assembly plants in the South has tended to shift the supplier industry also in that direction — for both the Big Three and the foreign-owned companies. For example, his model posits that if GM had located its new Saturn assembly plant in Michigan, instead of Spring Hill, Tennessee, there would have been 42 more supplier plants located in the Michigan-Indiana-Ohio auto belt and 37 fewer such plants in Tennessee and neighboring southern states. Similarly, if BMW had located its new plant in Michigan instead of near Spartanburg, South Carolina, about two dozen new supplier plants would have opened in the three auto belt states, Klier calculates, instead of states in the South.<sup>23</sup>

While the division in the structure of the steel industry is based on technology, all the automotive manufacturers are essentially producing the same type of products (passenger cars and light trucks) in the same way — assembly line methods, using parts and components brought in by truck from more or less remote locations. The key differences between the two sides of the domestic U.S. automotive industry can be summarized as:

- *Ownership.* The automotive industry, unlike the steel industry, is split between the traditional Big Three, all of which have their roots as U.S. companies, and the foreign-based manufacturers, all of which started by exporting cars to the United States, and which continue to supply about half their sales through imports.<sup>24</sup> This difference remains significant notwithstanding the fact that one of the Big Three, the Chrysler Group, is now owned by a German parent company, DaimlerChrysler AG. The Chrysler Group still is

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<sup>21</sup> The exceptions prove the rule, in that they were all built or operated as joint ventures with Big Three companies (GM-Toyota in Fremont, CA; Ford-Mazda in Flat Rock, MI; Chrysler-Mitsubishi in Normal, IL). For details on plant location and unionization, see *ibid.*, pp. 29-39.

<sup>22</sup> Both the Big Three and the international companies also have a number of assembly plants in Canada and Mexico, which are now integrated with U.S. operations. The Japanese-owned plants in Canada are non-union.

<sup>23</sup> Thomas Klier, “Determinants of Supplier Plant Location: Evidence from the Auto Industry,” Federal Reserve Bank of Chicago *Economic Perspectives* (3<sup>rd</sup> Qtr. 2005), pp. 10-12.

<sup>24</sup> CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, Fig. 9.

operated like a traditional Big Three company, with labor relations governed by contracts reached in collective bargaining. Both the largest integrated steel company operating in the United States (Mittal Steel) and the second-largest minimill operator (Gerdau Ameristeel) are foreign-owned, but this is a recent development, and the location of ownership appears to have played no systematic role in the policy perspectives of the two sides of the industry.<sup>25</sup>

- *Labor relations.* As noted above, all of the Big Three operations, and many of their suppliers are unionized. The international automotive manufacturers, and many of their suppliers are not. This difference does parallel an important distinction between the unionized integrated steel mills, and the generally non-union minimills.
- *Geographical focus.* The Big Three and their suppliers are concentrated in the industrial Midwest (and neighboring Ontario). In part, this is because plant closures have been a subject of collective bargaining, and also because most suppliers to an assembly plant are now located within about 400 miles (one day's truck drive by interstate highway) of the plant.<sup>26</sup> Similarly, the integrated steel industry is now mostly located in states surrounding the Great Lakes, while the minimill side of the industry is spread more widely around the country (it has been suggested that minimills should be called "market mills," because they can be located anywhere near the ultimate consumer).
- *Product focus.* The steel industry is increasingly divided on a product basis, with the integrated mills focused largely on high-quality sheet products, especially as used in automotive products and appliances, and the minimills focused more on "long" products, especially those used in construction, mineral exploration and development, and specialized industrial activities. In contrast, both the Big Three and the foreign-based auto manufacturers now produce across the full range of light vehicles sold in the American market, from passenger cars to minivans, sports utility vehicles, and pickup trucks. However, foreign-based manufacturers initially gained entree into the U.S. market through a reputation for producing small, fuel-efficient cars (Japanese and Korean

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<sup>25</sup> For example, Mittal Steel recently supported maintaining antidumping duties on steel plate imports from six other countries in an ITC "sunset review" case; *American Metal Market*, "Mittal, Lawmakers Tell ITC: Keep Duties" (Oct. 3, 2005 print ed.), p. 2; and, Mittal and Gerdau joined three other domestic producers initiating an antidumping suit against imported wire rod; *ibid.*, "U.S. Wire Rod Makers Rap Imports from 3 Nations" (Nov. 14, 2005), p. 1.

<sup>26</sup> See the data on this issue developed by Thomas Klier, as summarized in CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, pp. 35-37; also, pp. 79-81.

manufacturers) or for producing luxury products (especially Mercedes Benz and BMW). They now outsell the Big Three in these products, while the Big Three still dominate in sales of SUVs and other truck-based vehicles. This difference, while it has seriously affected relative market performance, has not so far led to radically different positions within the automotive industry on fuel economy policy issues.

In summary, the key issue within the steel industry that may provide an instructive parallel to the policy perspectives within the automotive industry is the division based on labor relations and to some extent geographical diversity. The Big Three, including many of their suppliers, and integrated steel mill companies have unionized workforces, based largely in the industrial Midwest. Newer competitors, the steel minimills and foreign-owned automotive manufacturers, are largely non-union, focused on “flexible” manufacturing approaches, and with production locations in states spread around the country. But, whereas the automotive industry is split between the traditional Big Three manufacturers, all domestic in origin, and foreign-based companies, foreign and domestic companies are on both sides of the division in the steel industry between integrated producers and the minimills.

## **Seeking Consensus on Legacy Costs: Lessons from the Steel Industry**

The American steel industry in 2001-03 succeeded in reaching a consensus on how to deal with the economic threat posed by rising imports during a period of domestic overcapacity and low demand. While a policy consensus was never absolute, integrated steel mill companies, minimill operators and unions together asked for trade remedies under Section 201 of the 1974 Trade Act. Representatives of these parties testified in favor of trade remedy action under this law before the U.S. International Trade Commission (ITC), had support from some Members of Congress in the process, and successfully lobbied for executive action.<sup>27</sup>

There was no such unity within the steel industry on the issue of legacy costs. As imports increased and the domestic steel industry foundered financially after 1998, the USWA supported comprehensive legislation, known as the “Steel Revitalization Act” (H.R. 808 in the 107<sup>th</sup> Congress). This bill, among other proposed measures, would have created government-managed health care and pension systems, financed by a tonnage surcharge on all steel sold in the United States (domestically produced or imported). The measure would have relieved the domestic integrated mills of legacy costs. But the measure was never endorsed by the American Iron and Steel Institute, representing both integrated producers and minimills. It was opposed by the Steel Manufacturers Association (SMA),

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<sup>27</sup> Archived CRS Report RL31842, *Steel: Section 201 Safeguard Action and International Negotiations*, by Stephen Cooney (available from author), pp. 1-24, examines in detail the development of U.S. policy on steel trade under the safeguard trade remedy process. Termination of the safeguard remedies is discussed in CRS Report RL32333, *Steel: Price and Availability Issues*, by Stephen Cooney, p. 1.

representing minimills, as a “government bailout” of the integrated steel mills. The SMA did not oppose assistance for retirees, unless such assistance was part of a package that might allow troubled integrated mills to continue operating. Less comprehensive legacy cost relief bills also failed to gain consensus support across industry. A petition to discharge H.R. 808 from committee and bring it to the House floor also failed to gain the necessary support of a majority of House members.<sup>28</sup>

In 1999 Congress approved the Emergency Steel Loan Guarantee Program (P.L. 106-51). Loans guaranteed under this program could be used to bolster pension funds and pay health care costs. But, in practice, the Steel Loan Guarantee program did not play a major role in alleviating financial difficulties in the steel industry. In total, three loan guarantees were taken up, primarily by two of the smaller integrated producers, Geneva Steel and Wheeling-Pittsburgh. One of the beneficiaries, Geneva, nevertheless later ceased operations and was liquidated. The program was extended and modified in later legislation, but efforts were not successful to increase the use of guarantees by liberalizing the conditions under which they are authorized. Such efforts were generally opposed by the SMA.<sup>29</sup>

Congressional action to provide relief beyond PBGC pension plan takeovers, in response to loss of benefits by steel industry retirees, consisted of a measure added to the Trade Act of 2002 (P.L. 107-210). This provides a health coverage tax credit (HCTC) equal to 65% of the cost of the premium for participating in a “qualified” health care plan, available to persons who receive their pension from the PBGC, or others who receive Trade Adjustment Act Assistance.<sup>30</sup> A recent study by a private research body suggests that about 22% of eligible persons may actually be receiving the HCTC, not counting people who are disqualified because they have Medicare or other coverage, such as through their spouse.<sup>31</sup> Regardless of whether they are eligible for the HCTC, retirees who lose their health insurance also lose employer-paid prescription drug benefits that often are more generous than any alternative coverage they can acquire, including the new Medicare prescription drug benefit that starts in 2006.

The lesson that may be drawn from this history for those concerned with legacy costs in the automotive industry is that a unified industry position on any plan will likely be necessary to resolve this issue, if the industry is to seek any government guarantees or assistance. This means, initially, the full support of the Big Three, the UAW and other unions. It may also mean the acquiescence, if not the active support, of the foreign-owned manufacturers in the United States and their representative

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<sup>28</sup> Details of these legislative proposals and positions are discussed in Archived CRS Report RL31279, *Steel: Legacy Cost Issue*, by Stephen Cooney (available from author), pp. 8-11.

<sup>29</sup> The most recent CRS summary of the Emergency Steel Loan Guarantee program is in CRS Report RL31748, *The American Steel Industry: A Changing Profile*, by Stephen Cooney, pp. 19-23.

<sup>30</sup> *Ibid.*, pp. 2-3, 14-17. For details on how this program operates, see CRS Report RL32620, *Health Coverage Tax Credit Authorized by the Trade Act*, by Julie Stone and Bob Lyke.

<sup>31</sup> *Ibid.*, pp. 11-12; Economic and Social Research Institute, “Limited Take-Up of Health Coverage Tax Credits and the Design of Future Tax Credits for the Uninsured,” esp. pp. 2-5.

organizations. Historically, these companies and organizations have been the targets of regulations and legislation, such as import quotas and origin labeling requirements, that were advocated by U.S. unions and the Big Three.<sup>32</sup> But now a quarter or more of all U.S. workers in the motor vehicle and automotive parts industry (not counting employees of Chrysler) work for foreign-owned companies.<sup>33</sup> Many of these jobs are located in states outside the traditional auto belt and are critical to those states' economies. Furthermore, the spread of automotive plants to these states suggests that generating a congressional consensus on how to deal with the legacy cost issue may be difficult. As seen with the issue of steel legacy costs, an approach to the automotive legacy issue that does not address the different perspectives of all parts of the automotive manufacturing industry, as it presently exists today in the United States, is unlikely to succeed.

## **Congressional Options on Automotive Legacy Costs**

As mentioned above, in the late 1970s and early 1980s, the Big Three and the UAW sought to gain relief from the rising competitive force of imports through a number of legislative and regulatory policy actions. These included an unsuccessful effort to win safeguard trade relief, a congressionally approved loan guarantee that helped save Chrysler Corporation from bankruptcy, and a voluntary restriction on cars exported to the United States from Japan. By the late 1980s, the Big Three were again profitable, and the interest in such measures, mixing trade and industrial policy, dissipated. In the 1990s, the Clinton Administration tried to force Japan to open its automotive parts market, threatening to retaliate against Japanese luxury car exports to the United States, and did achieve a Japanese commitment to alter certain policies.<sup>34</sup>

At the present time, there are no legislative proposals to assist the Big Three and its parts suppliers through such trade remedies or other policies involving broad and direct government intervention in the market. In September 2005 Ford CEO William C. Ford, Jr. wrote President George Bush to suggest a meeting at which auto makers and others interested in energy security could discuss how to develop initiatives to find a solution to this issue. In a November 22, 2005, speech in Washington, DC, Ford expanded on this topic by laying out a plan to enhance both domestic automotive manufacturers competitiveness and improved fuel economy. Ford's plan included:

- Urging Congress to increase the research and development tax credit to more directly support companies working on advanced vehicles, components, and fuel technologies;

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<sup>32</sup> CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, pp. 56-59.

<sup>33</sup> *Ibid.*, pp. 31-32.

<sup>34</sup> This history is summarized in *ibid.*, pp. 54-58.

- Urging Congress to consider tax incentives to help convert existing — but outmoded — plants into “high-tech” facilities;
- Calling for investment in American workers who build advanced technology products with training programs and incentives to upgrade worker skills;
- Suggesting that by 2010, where feasible, governments at all levels should purchase only hybrids or other alternatively fueled cars;
- Expanding infrastructure for ethanol fuels, by increasing the available number of fueling stations;
- Requesting publicly that President Bush convene a group of automakers, parts suppliers, fuel providers and government agencies “to address America’s energy challenges.”<sup>35</sup>

One bill that links improving fuel economy with helping companies to pay for retiree health care, S. 2045, was introduced by Senator Barack Obama on November 17, 2005. This bill would establish a program to pay 10% of domestic automobile manufacturers’ retiree health care costs, if companies invested at least 50% of the savings in development and production of vehicles using enhanced or innovative fuel-saving or alternative fuel technologies. A range of other legislative proposals now under consideration that may impact the automotive sector, including especially fuel economy and environmental proposals that may have a competitive impact, are discussed in an earlier CRS Report.<sup>36</sup> Beyond these issues, Congress has recently approved or is presently considering the following issues regarding pensions and health care, which could have important consequences for automotive manufacturers.

## **Tax Deductions for Legacy Cost Contributions**

Under current law, employers may claim income tax deductions for contributions to qualified pension funds and for actual expenses incurred for health care claims by employees and retirees. Employers may also claim a tax deduction for contributions to collectively bargained trusts for unionized employees’ retiree health care, known as Voluntary Employee Beneficiary Associations (VEBAs).<sup>37</sup> In 2003, Congress passed the Medicare Prescription Drug, Improvement, and Modernization Act, which subsidizes companies that maintain or establish prescription drug benefit coverage for employees and retirees, and excluded this

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<sup>35</sup> Summary from Ford press release, “Bill Ford: Through Innovation, America Can Address Energy, Manufacturing Challenges” (Nov. 22, 2005), and text of Ford’s speech to National Press Club, Washington, DC (Nov. 22, 2005), as provided by Ford Motor Co. Also, letter from Bill Ford to President George W. Bush (Sept. 22, 2005).

<sup>36</sup> CRS Report RL32883, *U.S. Automotive Industry: Policy Overview and Recent History*, by Stephen Cooney and Brent D. Yacobucci, pp. 7-11, 83-96.

<sup>37</sup> A description of VEBAs and their restrictions under U.S. tax law, as prepared by CRS, is in U.S. Senate, Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions* (S.Prt. 108-54, Dec. 2004), pp. 479-86.

subsidy from calculation of gross income.<sup>38</sup> In the case of bankrupt steel companies, VEBAs proved inadequate to cover fully retiree health care costs, and they may also be inadequate in the automotive industry. Moreover, tax deductions for actual health care cost claims, and VEBA and pension fund contributions may not be helpful for companies that are losing money.

## PBGC Reform

The 109<sup>th</sup> Congress has studied the rapidly rising burdens on PBGC occasioned by the takeover of pension plans of bankrupt companies, especially among airlines and in the steel industry.<sup>39</sup> The House Education and Workforce Committee has approved a comprehensive PBGC reform measure, H.R. 2830, which would raise premiums, tighten funding requirements of insured pension plans and change the bases for calculating funding adequacy.<sup>40</sup> The House Ways and Means Committee has also ordered an amended version of this bill to be reported. Meanwhile, the Senate on November 16, 2005, approved S. 1783, co-sponsored by the respective chairmen and ranking members of the Finance and Health, Education, Labor and Pensions (HELP) Committees on a vote of 97-2.<sup>41</sup> Concerns have been raised regarding this bill by Ford and GM, as well as by the UAW, who argue that some provisions will put even more pressure on companies or plans that are already losing money.<sup>42</sup> Also, narrower provisions have also been added to each chamber's deficit reduction and budget reconciliation bill (S. 1932 §7201 and H.R. 4241 §2201). These measures would establish higher premiums and require that any company that

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<sup>38</sup> CRS Report RL31966, *Overview of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003*, by Jennifer O'Sullivan et al.

<sup>39</sup> The 108<sup>th</sup> Congress had approved, and President Bush signed into law, a measure that included two years of pension fund contribution relief to airline and steel companies (P.L. 108-218).

<sup>40</sup> H.R. 2830 and other proposed legislation are analyzed in CRS Report RL32991, *Defined Benefit Pension Reform for Single-Employer Plans*, by Neela K. Ranade and Paul Graney.

<sup>41</sup> *CQToday*, "House Pension Overhaul on Tap as Senate Version Passes" (Nov. 16, 2005); *Washington Post*, "Senate Passes Bill to Require Full Funding of Private Pensions" (Nov. 17, 2005), p. D1; *Wall Street Journal*, "Pension Measure Passes in Senate, But Hurdles Loom" (Nov. 17, 2005), p. A5.

<sup>42</sup> Harry Stoffer, "Pension Reforms Would Cost the Auto Industry," *Automotive News* (Oct. 24, 2005), p. 4; Jeff Plungis, "Big 3 Fear Pension Reforms," *Detroit News* (Oct. 31, 2005). The National Association of Manufacturers (Oct. 3, 2005) and the Business Roundtable (Oct. 5, 2005), of which the Big Three are members, and the UAW (Nov. 14, 2005) all wrote the Senate expressing concerns regarding S. 1783, which would require pension plan sponsors to increase contributions when credit ratings fall and limit the "smoothing" of pension plan earnings to a twelve-month period. Senators DeWine and Mikulski reportedly put a hold on this legislation, but lifted it after receiving assurances that these issues would be worked out in conference with the House (*CQ Today*, Nov. 15, 2005, p. 13; *Wall St. Journal*, *loc. cit.*).

reorganizes under Chapter 11 bankruptcy, and thereby terminates its insured pension plan, pay PBGC \$1,250 per insured employee for three years.<sup>43</sup>

## Reducing Health Care Costs

By the Medicare Modernization Act of 2003 referenced above, Congress required the Secretary of Health and Human Services to adopt electronic prescription standards and improve electronic exchange of health care data. President Bush has called for adoption of interoperable electronic health records within 10 years.<sup>44</sup> A number of bills have been introduced in the 109<sup>th</sup> Congress to increase federal investment and leadership in health care information technology. On July 27, 2005, the Senate HELP Committee reported S. 1418, the Wired for Health Care Quality Act, co-sponsored by its chairman and ranking member, Senators Enzi and Kennedy. Similarly, Congress is considering basing a portion of providers' payments under Medicare on the quality of care, a system known as "pay for performance."<sup>45</sup> Pay for performance initiatives are also being undertaken by the private sector, with the support of automotive companies.<sup>46</sup> Whether any of these initiatives actually would reduce costs remains to be seen.

## Expanding Medicare and Government Health Care Insurance

Another approach is to allow those not yet eligible for Medicare to "buy in" to the program. H.R. 2072, the Medicare Early Access bill, introduced by Representative Pete Stark with 103 co-sponsors, would allow individuals aged between 55 and 65 this option, and would help them pay for the cost with a tax credit. A further idea that has been proposed is some form of government insurance for very high health care costs. This issue has not taken the form of a specific legislative proposal. A recent editorial in the industry weekly *Automotive News* asserted, "Because of the health care cost trauma in Detroit, a catastrophic-claims pool underwritten by the government might be a good first step."<sup>47</sup>

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<sup>43</sup> For a comparison of these measures, see CRS Report RS22315, *Budget Reconciliation and the PBGC*, by Neela K. Ranade. Note that the bankruptcy provision apparently would not apply to Delphi, as both bills exclude filings before the bankruptcy law changed on Oct. 17, 2005.

<sup>44</sup> He has appointed Dr. David Brailer as National Coordinator for Health Information Technology to help promote this cause; "This Man Wants to Heal Health Care," *Business Week* (Oct. 31, 2005), pp. 75-80. Note, however, that there are also costs associated with implementing such a broad "Health Care IT" program.

<sup>45</sup> CRS Report RL32837, *Science and Technology Policy: Issues for the 109th Congress*, by Marcia S. Smith, pp. 25-26.

<sup>46</sup> The two largest employer groups paying bonuses to providers of high-quality health care are the "Leapfrog Group," which focuses on hospitals, and "Bridges to Excellence," which focuses on physicians. GM and Ford are members of both organizations.

<sup>47</sup> *Automotive News*, "Washington Must Help the Industry with Health Care" (Oct. 31, 2005), p. 12.

## Legacy Costs and the Issue of Moral Hazard

Overlaying these considerations regarding defined benefit legacy costs, as presented in a lengthy analysis in the *New York Times*, is the question of “moral hazard,” which means that insurance against loss encourages more risk-taking than would otherwise occur. The term became familiar during the 1980s, in financial crises such as foreign government debt problems, and, as the author of the *Times* article writes, “foolish risks taken by S&L’s of that era in part because their deposits were insured.” He continued:

Given that pension promises do not come due for years, it is hardly surprising that corporate executives and state legislators have found it easier to pay off unions with benefits tomorrow rather than with wages today. Since the benefits were insured [in the case of pensions], union leaders did not much care if the obligations proved excessive. During the previous decade especially, when it seemed that every pension promise could be fulfilled by a rising stock market, employers either recklessly overpromised or recklessly underprovided — or both — for the commitments they made.<sup>48</sup>

On the other hand, such a view may seem unduly harsh, in that workers often accepted the security of defined benefit promises (pensions and lifetime health care), as part of a deal involving voluntary early retirement, layoffs and downsizing in industries and companies that needed fewer and fewer workers per unit of output or faced increased competitive pressures. As in steel, so now in motor vehicles, Congress may reconsider the public sector role in determining whether the promises made as part of these legacy costs are kept.

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<sup>48</sup> Roger Lowenstein, “The End of Pensions,” *New York Times Magazine* (Oct. 30, 2005)

