The Cascading Effects of the Collapse of American Automakers

Implications for Healthcare and Nonprofits

A REPORT BY

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94
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35

TABLE OF CONTENTS

INTRODUCTION

The collapse of one or more of the "Big Three" American automobile manufacturers – General Motors, Ford, and Chrysler – will hurt virtually every area of the reeling U.S. economy, including the healthcare system and the nonprofit sector. Most arguments over the possibility of government intervention focus exclusively on the obvious stakeholders: employees and shareholders of the Big Three, employees and shareholders of U.S. automotive parts suppliers, and taxpayers. These parties bear what we will call "primary" economic costs, since they will feel the direct effects of such a contraction. A complete analysis of the issue, however, also should consider such "secondary" economic costs as the consequences for healthcare and nonprofits. This brief attempts to assess both types of costs and provides policy recommendations based on the assessments.

We will proceed by looking first at the primary costs, since they represent the large and direct economic effects that ultimately produce the secondary costs. Based on assessments of the primary costs, we will examine the secondary costs that interest us: the impact on healthcare and nonprofits. Finally, we will use both assessments to make recommendations to policymakers and will conclude with some closing thoughts.

TWO EXISTING STUDIES: ASSESSMENTS OF PRIMARY COSTS

In November 2008, the Michigan-based Center for Automotive Research (CAR) released the results of a study[1] that estimates the economic impacts of the collapse of one or more of the Big Three. The study considers two scenarios: a "100% contraction" scenario, in which all three companies cease all U.S. operations, and a "50% contraction" scenario, in which their combined domestic employment and domestic production both fall by half. (According to the report, the latter scenario may result from the failure of one of the three firms.) The 100% contraction scenario assumes not only that Big Three production falls to zero, but also that U.S. production by foreign automotive companies falls to zero in the first year following the shock. (The rationale given is that U.S. automotive parts suppliers – which, according to the report, typically do not serve export markets – likely will need to either restructure or liquidate their businesses if this occurs.) In the 50% contraction scenario, Big Three production and employment both fall to zero in the first year but recover to half of their original levels in the second and third years. For the international automotive companies, production would fall by half in the first and second years and return to its original level by the third year. Neither scenario assumes that foreign automakers will reduce the sizes of their U.S. workforces.

For each scenario, the report presents a three-year forecast of the impact on employment, personal income, and government debt. These forecasts reflect not only the impact on the Big Three and their suppliers (what the report calls "direct" and "indirect" effects, respectively), but also the resulting decline in economic activity ("spinoff" effects). Table 1 presents the main results.

Table 1: Summary of CAR Report Results

		100% Contraction	50% Contraction
Fall in Employment	After 1 Year	2,951,344	2,462,375
	After 2 Years	2,462,016	1,497,734
	After 3 Years	1,771,563	1,005,594
3 Year Personal Income Loss		$398.2 billion	$275.7 billion
3 Year Increase in Government Debt[2]		$156.4 billion	$108.1 billion

Source: Cole, David et al., "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers." CAR Research Memorandum, November 4, 2008.

1 Cole, David et al., "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers." CAR Research Memorandum, November 4, 2008.

2 Measured as the sum of the increase in transfer payments, decrease in Social Security receipts, and decrease in income tax revenue on the local, state, and federal levels.

The forecasts paint a bleak picture, even for the less severe 50% contraction scenario. To see the estimated employment impact in perspective, consider the fact that the number of employed workers in the U.S. fell by just under 3 million between December 2007 and December 2008.[3] As the last row indicates, the potential impact to the government's budget in the event of a contraction is substantial. Ultimately, taxpayers will have to repay the government's debt, so the firms' survival is in their interest as well.

Although this report does not include policy recommendations, many advocates of government intervention portray it as a warning of the consequences of inaction. This interpretation is misleading, because the report does not conclude that either contraction scenario would occur if the government were to do nothing. (Its authors do claim, however, that "[t]he circumstances are such that either of these scenarios is possible, and indeed one or the other is probable, within the next 12 months.") Furthermore, the assumption (from the 100% contraction scenario) that foreign automakers' U.S. production will fall to zero in the first year is questionable. Suppliers that are restructuring will not necessarily reduce their own production levels so substantially that foreign automakers cannot operate at all, and, although those suppliers that liquidate will cease production, they also will sell off their inventories before ending their operations. Furthermore, foreign automakers with U.S. production facilities may turn to international suppliers, even if they do not currently do so. Thus, the first-year projections of output may be understated.

> "[T]he potential impact to the government's budget in the event of a contraction is substantial... so the firms' survival is in [taxpayers'] interest as well."

Analysts from the Washington-based Heritage Foundation also raise some criticisms.[4] They argue that a 30% contraction for each of the three years is more likely than the report's two contraction scenarios. (Their estimate of 30% is based on the fact that "the automakers have suggested that they are at least 30 percent short of needed cash flow.") They also note that the model used to produce CAR's results fails to account for consumer and producer reactions to changing economic conditions. In particular, the Heritage analysts point out that such a contraction may lead many consumers to the used car market. The resulting expansion of this market would dampen some of the report's projected "indirect" and "spinoff" effects. Finally, the Heritage analysts note that an increase in U.S. automobile imports will put downward pressure on the U.S. dollar. In response, the demand for U.S. exports will rise, triggering increases in employment and production in the exporting industries. (In practice, trade balances take some time to respond to exchange rate changes; the Heritage report does not state how long its authors expect this response time to be.)

Using an alternative forecasting model, the Heritage analysts estimate the first-year total employment impact to be a loss of 435,000 jobs. While this figure is significant, it is substantially lower than the CAR estimate. (The Heritage report does not give revised estimates for the CAR report's other figures, but it is reasonable to expect that they, too, would be associated with less severe consequences.) Given the Heritage report's relative lack of transparency with respect to methodology and assumptions, assessing its overall quality is difficult. Certainly

3 U.S. Bureau of Labor Statistics, "The Employment Situation: December 2008." January 9, 2009.

4 Campbell, Karen A. and Paul L. Winfree, "Bankruptcy of Detroit's Big Three Auto Companies: New Economic Impact Estimates." Heritage WebMemo, December 8, 2008.

the criticisms that it raises are valid, and the 30% contraction scenario, while not given an exceptionally sound justification, is less arbitrary than either of the CAR report scenarios. So, in some respects, it may be an improvement over the CAR report.

However, most economists' views reflect, if nothing else, a sense of urgency over the state of the American automotive industry. Jeffrey Sachs (professor, Columbia University) notes the potential multiplier effects of a collapse on overall unemployment; not only would the 1 million assembly and parts workers lose their jobs, but "millions more" would suffer as well.[5] In his December 4, 2008, testimony in front of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Mark Zandi (chief economist and cofounder, Moody's Economy.com) estimated the employment multiplier for the auto assembly industry to be about 9.1: for every job lost in auto assembly, about 9.1 additional jobs would be lost in various sectors. Even Peter Morici (professor, University of Maryland's Robert H. Smith School of Business), a proponent of Chapter 11 restructuring for the Big Three, noted in his November 18, 2008, testimony in front of the same committee that "[w]hen Americans buy automobiles from the Detroit Three, more is contributed to the vitality of the U.S. economy than when Americans buy vehicles assembled here by transplants or imports. These vehicles have more U.S. content in terms of jobs, engineering and profits than do foreign nameplate vehicles." Expert opinions generally depict worst-case scenarios that more closely resemble the one from the CAR report than the one from the Heritage Foundation's report.

> **"For every job lost in auto assembly, about 9.1 additional jobs would be lost in various sectors."**

So far we have analyzed only the primary costs of contraction. Now we turn to a couple of the secondary costs: the impact on healthcare and nonprofits.

5 Sachs, Jeffrey D., "A Bridge for the Carmakers." *Washington Post,* November 17, 2008.

SECONDARY COST: HEALTHCARE SYSTEM

Although the CAR report's results do not include the secondary costs that interest us, its closing paragraph does allude to them. Specifically, it mentions that the bankruptcy of any of the Big Three will jeopardize that firm's pension fund, thus straining the resources of the Pension Benefit Guarantee Corporation (PBGC). Furthermore, the report notes, such a bankruptcy will have significant implications for the healthcare system. As stated in the report: "The Detroit Three are directly and indirectly responsible for funding the health care of 2 million employees, retirees, and dependents of their own companies and their suppliers." A substantial reduction in this funding not only would impose considerable hardship on its beneficiaries, but also would affect many others, namely, general taxpayers, as well.

Even if one argues that the CAR report's employment impacts are pessimistic, it is clear that a major contraction would produce a large number of layoffs among the automakers and their suppliers, and that the resulting unemployment would be persistent. While it is true that some workers would find employment elsewhere, overall their prospects would be bleak. First of all, real motor vehicle output for the first three quarters of 2008 fell by over 13%[6] from the same period in 2007. Furthermore, over the same period, national income for the durable goods manufacturing sector dropped by over 6%,[7] and employment for that sector fell by 269,000 workers.[8] Given these indicators of the ongoing contraction in both the automotive industry and the manufacturing sector, workers who are laid off en masse as a result of a further contraction among the Big Three could remain jobless for quite some time. A further rise in unemployment would result from the fall in spending by these unemployed workers. (On average, the unemployment spells of workers laid off during the second wave most likely would be shorter than those laid off during the first wave.)

We can use the CAR report's figures to derive an estimate of the impact on government healthcare spending. Suppose that unemployment rises by 2 million workers. (This figure lies between the one-year employment estimates from the CAR report's 50% and 100% contraction scenarios.) Total government spending on Medicaid in 2007 was about $514.3 billion ($190.6 billion by the federal government[9] and $323.7 billion by state governments[10]). According

6 U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 7.2.5B: Motor Vehicle Output.

7 U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 6.1D: National Income Without Capital Consumption Adjustment by Industry.

8 Congressional Budget Office, "Factors Underlying the Decline in Manufacturing Employment Since 2000." CBO Economic and Budget Issue Brief, December 23, 2008.

9 Congressional Budget Office, "Historical Budget Data." September 9, 2008.

10 U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 3.12: Government Social Benefits.

to a 2008 study conducted by the California-based Urban Institute and commissioned by the Washington-based Henry J. Kaiser Family Foundation, a 1% increase in the national unemployment rate would have the following consequences:[11]

- Enrollment in Medicaid and SCHIP (State Children's Health Insurance Program) of an additional 400,000 children and 600,000 non-elderly adults.
- An increase in the number of uninsured individuals of 1.1 million.[12]
- A 3% to 4% decrease in state revenues.
- Increases in Medicaid and SCHIP costs of $2.0 billion for the federal government and of $1.4 billion for state governments.

According to the Bureau of Labor Statistics, unemployment in December 2008 was 11 million individuals, or 7.2% of the labor force.[13] An additional 2 million unemployed workers would bring the national unemployment rate to 8.4%, in turn raising total Medicaid and SCHIP costs by $4.1 billion. Note, however, that this figure does not account for rising healthcare costs or for the growing unemployment that is unrelated to the automotive industry's contraction, both of which would spur further increases in government healthcare spending. By increasing the government's deficit, the increase in Medicaid spending also increases the burden on taxpayers.

In addition, the above analysis also does not consider the effects on Big Three pensioners and retirees. If a major source of their healthcare funding were to evaporate, they, too, would have to turn to Medicaid, Medicare, and other government welfare and healthcare programs. Most of them would fall into the elderly or disabled categories. According to the Congressional Budget Office, in 2006 these groups composed a modest 26.1% of total Medicaid enrollment; however, their benefit payments accounted for a full 68.5% of total Medicaid benefit payments.[14] According to another report by the Kaiser Family Foundation, Medicare provides health insurance coverage to roughly 45 million elderly or disabled people.[15] The report also states that in 2009, Medicare spending is expected to account for roughly 13% (over $400 billion) of the federal budget and for 19% of total healthcare expenditures. A sudden increase in these pensioners' and retirees' reliance on government healthcare programs will strain the government's budget significantly. Ultimately, a further increase in taxpayer burden will ensue.

> **"If a major source of [Big Three pensioners' and retirees'] healthcare funding were to evaporate, they... would have to turn to Medicaid, Medicare, and other government welfare and healthcare programs."**

Former President George W. Bush's action on the situation facing the Big Three reflects his administration's view that the potential consequences of inaction were severe enough to warrant

11 Kaiser Commission on Medicaid and the Uninsured, "Medicaid, SCHIP, and Economic Downturn: Policy Challenges and Policy Responses." April 28, 2008.

12 This figure may not have an explicit accounting cost, but it certainly has a sizable economic cost: the fall in social welfare that results when 1.1 million individuals suddenly lose healthcare coverage.

13 U.S. Bureau of Labor Statistics, "The Employment Situation."

14 Congressional Budget Office, "Medicaid Spending Growth and Options for Controlling Costs." CBO Testimony, July 13, 2006.

15 Henry J. Kaiser Family Foundation, "Medicaid: A Primer." December 2, 2008.

government intervention. On December 19, 2008, he announced the provision of funds from the Troubled Asset Relief Program (TARP) to assist domestic automotive firms in becoming "financially viable."[16] His plan provided $13.4 billion ($9.4 billion for GM and $4 billion for Chrysler) in loans from the first $350 billion tranche of the TARP fund, and will provide an additional $4 billion for GM from the second $350 billion tranche of the fund in February 2009.[17]

> **Even if the companies survive, the restructuring that enables their survival could include reductions in benefits programs.**

Following is an excerpt from the fact sheet that accompanied Bush's announcement of the allocation of TARP funds for GM and Chrysler:

> The direct costs of American automakers failing and laying off their workers in the near term would result in a more than one-percent reduction in real GDP growth and about 1.1 million workers losing their jobs, including workers from auto suppliers and dealers. Many workers would apply for unemployment benefits, and to the extent that retirees and other workers lost health insurance, apply for Medicaid. These new unemployment claims could cost about $13 billion and would likely add sizeable costs to State Medicaid programs. Additionally, suppliers may not be able to absorb losses from writing off the accounts payable owed by auto manufacturers and may not be able to downsize quickly, resulting in remaining auto companies having supply chains disrupted. These effects on our economy could multiply as a result of the failure of these companies.[18]

The extension of aid to automotive companies, however, will not necessarily prevent a rise in secondary costs. Obviously, the aid packages do not guarantee that the companies will survive (although the aid presumably will increase their chances of survival). Furthermore, the aid packages are loans that are supposed to allow the companies to continue their operations while they restructure. Hence, even if the companies survive, the restructuring that enables their survival could include reductions in benefits programs. Consider the following conditions of the aid package:[19]

- A firm that is not financially viable (defined as having a positive net present value after accounting for all current and future costs and being able to fully repay the loan) by March 31, 2009, must repay the loan immediately.
- By December 31, 2009, the firm must either show that its wages and work rules are competitive with those of transplant auto manufacturers or report why it has failed to achieve competitiveness and convince the government that it will, nonetheless, achieve long-term viability.

While these conditions impose no explicit restrictions on the firms' spending, terms such as "financially viable" and "competitive" imply that they will be forced to cut costs, especially those that are lower for their foreign competitors or inessential for day-to-day operations.

Spending on benefits, particularly for retirees, falls into this category. Historically, such costs have put the Big Three

16 White House Office of the Press Secretary, "Fact Sheet: Financing Assistance to Facilitate the Restructuring of Auto Manufacturers to Attain Financial Viability." White House Press Release, December 19, 2008.

17 Agence France-Press, "GM, Chrysler to Share U.S. Bailout: White House." December 19, 2008.

18 White House Office of the Press Secretary, "Fact Sheet: Financing Assistance."

19 Ibid.

at a major competitive disadvantage compared to Toyota and other foreign automakers with U.S. operations. Even after the United Auto Workers (UAW) agreed to lower benefits spending in contract negotiations with GM and Ford in 2005 (but before the latest contract negotiations in 2007), nearly 85% of Toyota's labor-cost advantage over GM and nearly 78% of its advantage over Ford could be explained by differences in benefits spending – and retiree benefits spending accounted for a substantial portion of overall benefits spending.[20] In 2006, Pete Gritton (head of human resources, Toyota's U.S. manufacturing operations) noted the following regarding Toyota's comparatively small retiree benefits packages: "We want to avoid commitments when we have no control over their costs. We can't build things in such a way that we won't be able to keep our commitments later."[21] Such commitments, which were made decades ago, certainly have drained the Big Three's financial resources as their retiree populations have grown. In 2005, for example, GM made $5.4 billion in healthcare payments for 141,000 employees, 449,000 retirees, and their dependents.[22] Toyota did not provide exact healthcare spending figures in its annual report, but noted that the healthcare costs for its retirees were "not material."[23]

> **"Historically, [spending on benefits] ha[s] put the Big Three at a major competitive disadvantage compared to Toyota and other foreign automakers with U.S. operations."**

Certainly some of the disparity in retiree spending can be attributed to volume: whereas GM had 357,000 union retirees at the end of 2006, Toyota had only 269.[24] Furthermore, the 2007 contracts with the UAW ostensibly have made the Big Three more competitive with foreign automakers. In their November 19, 2008, testimonies in front of the U.S. House of Representatives Financial Services Committee, the CEOs of the Big Three – G. Richard Wagoner, Jr. of GM, Alan Mulally of Ford, and Robert Nardelli of Chrysler – claimed that their recently negotiated agreements have essentially eliminated the "competitive gaps" that existed between their operations and those of Toyota. In his own testimony at that same hearing, Ron Gettelfinger (president, the UAW) noted the following facts about the contracts negotiated in 2005 and 2007:

- Newly hired employees at the companies will not be covered under the traditional retiree healthcare and defined benefit pension plans.
- Starting in 2010, healthcare costs for existing retirees will be paid from a voluntary employee beneficiary association (VEBA), rather than by the companies directly.

These points indicate that the Big Three and the UAW already have taken important steps. While it still is too early to measure the new UAW contracts' full benefits, a 2008 study by Oliver Wyman shows that the competitive gap had shrunk considerably by the end of 2007.[25]

20 Green, Jeff, "Toyota Rules in Marketplace, but U.S. Automakers' Shares Gain." Bloomberg News, June 4, 2007.
21 Porter, Eduardo, "Japanese Cars, American Retirees." *The New York Times*, May 19, 2006.
22 Ibid.
23 Ibid.
24 Green, "Toyota Rules in Marketplace."
25 Oliver Wyman, "Lean Improvements, Worker Buyouts Bring Detroit Three Productivity Closer to Asian Rivals, Says Oliver Wyman's Harbour Report 2008." Oliver Wyman Press Release, June 5, 2008.

Among the study's key findings are the following:

- Among the Big Six automakers (GM, Ford, Chrysler, Toyota, Honda, and Nissan), the gap – in terms of total manufacturing labor – between most and least productive fell to 3.50 labor hours per vehicle in 2007 from 10.15 labor hours per vehicle in 2003.
- Chrysler and Toyota each recorded an average of 30.37 labor hours per vehicle in 2007.
- Pre-tax per-vehicle profits in 2007 were as follows:
    - » Honda: $1,641
    - » Nissan: $1,641
    - » Toyota: $922
    - » Chrysler: -$412[26]
    - » GM: -$729
    - » Ford: -$1,467
- Profitability gaps between the Big Three and the three foreign automakers result primarily from two factors:
    - » The Big Three have higher healthcare, pension, and sales incentives costs.
    - » The Big Three support more dealers relative to their market shares than the others do.

Assuming that Toyota, Honda, and Nissan make no changes of their own, the higher healthcare and pension costs borne by the Big Three likely will continue to shrink over time as a result of the 2007 agreements with the UAW, and also as the retiree populations of Toyota, Honda, and Nissan grow. However, if the latter cut their own costs (healthcare or other) in response to difficult market conditions, the Big Three will have to follow suit. In particular Toyota, which is often used as the industry benchmark, recently announced that it expects to sustain a $5 billion operating loss for the fiscal year ending March 31, 2009.[27] Cost-cutting moves at Toyota may force the Big Three to dig even deeper to remain competitive. If they were to reduce healthcare spending even more, some workers, despite still being employed, may need to apply for supplemental government healthcare coverage. (Further reductions of employee benefits would be difficult to obtain, however, given the UAW's bargaining position.)

> **"In particular Toyota, which is often used as the industry benchmark, recently announced that it expects to sustain a $5 billion operating loss for the fiscal year ending March 31, 2009."**

The high healthcare costs borne by the Big Three highlight an important issue: rising healthcare costs in the U.S. In June 2005, several southern states were expressing enthusiasm over the prospect of being home to a new U.S. manufacturing plant that Toyota was thinking of building in the U.S. In the end, however, Toyota built its plant in the Canadian province of Ontario. According to some analysts, this decision was motivated at least in part by Canada's national health insurance system, which saves businesses the costs of providing healthcare coverage to their employees.[28] As

26 The figure for Chrysler reflects only the first nine months of 2007.

27 Fackler, Martin and Micheline Maynard, "In the Red, Toyota Sees Loss Tripling." The New York Times, February 6, 2009.

28 Krugman, Paul, "Toyota, Moving Northward." *The New York Times*, July 25, 2005.

goods and service markets become more globalized, businesses need to become increasingly competitive on an international level, and large healthcare costs discourage multinational firms from building facilities and hiring workers in the U.S. This point often is used to support calls for a universal healthcare system. While the government certainly should look into the feasibility, costs, and benefits of such a system, this "solution" misses the point: the primary underlying issue is not the absence of national healthcare coverage, but the rising healthcare costs. A simple shift of payment responsibilities from firms to the government will just create a new problem by increasing the national debt.

"Over the years, high healthcare costs have ravaged the Big Three's resources, strained federal and state finances, and imposed considerable hardship on individuals, particularly those who are uninsured."

An October 2008 report published by the New Jersey-based Robert Wood Johnson Foundation provides several facts related to U.S. healthcare spending:[29]

- In 2006, U.S. healthcare spending amounted to $2.1 trillion, or 15.3% of GDP.
- This proportion is the highest among OECD (Organisation for Economic Co-operation and Development) countries and is over 6% higher than the OECD average of 8.9%.
- While most OECD countries provide near-universal healthcare coverage, in 2006 the U.S. had 47 million uninsured people (15.8% of the population).
- Healthcare spending in the U.S. rose by an average annual rate of 9.9% between 1960 and 2006, while GDP increased by an average of 7.3% per year over the same period.

Furthermore, the Congressional Budget Office projects that Medicare benefit spending will rise from its expected level of $477 billion in 2009 to $871 billion in 2018.[30] These facts describe a situation that is truly unsustainable, regardless of whether healthcare costs are covered by the government, firms, or individuals. According to the Johnson Foundation report:

> The dominant driver of long-term cost trends is advancing medical technology, where new options for diagnosis and treatment often replace older technologies that are less expensive or provide opportunities when none existed before. Advancing technology may have a particularly large impact on spending in the United States because of few requirements that effectiveness be demonstrated before technologies are used broadly and concern that their application tends to go beyond those patients likely to benefit the most from them. Other key factors are increasing rates of obesity and the likelihood that the delivery system is not generating increases in efficiency in line with the potential for such gains.[31]

We will return to these findings later, when we make our policy recommendations. Over the years, high healthcare costs have ravaged the Big Three's resources, strained federal and state finances, and imposed considerable hardship on individuals, particularly those who are uninsured. The prohibitively high – and rising – costs must be addressed as part of any comprehensive solution.

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29 Ginsburg, Paul B., "High And Rising Health Care Costs: Demystifying U.S. Health Care Spending." Robert Wood Johnson Foundation Research Synthesis Report No. 16, October 2008.

30 Henry J. Kaiser Family Foundation, "Medicaid: A Primer."

31 Ginsburg, "High and Rising Health Care Costs."

SECONDARY COST: NONPROFIT SECTOR

In 2007, the GM Corporation and its philanthropic arm, the GM Foundation, together gave $58.7 million to various philanthropic activities[32]; the Ford Motor Company and the Ford Motor Company Fund together made $54.4 million in philanthropic contributions[33]; and the Chrysler Foundation made $19.3 million in grants to charitable organizations.[34] Restructuring by the Big Three – even if successful – likely will require a marked, though perhaps temporary, reduction in philanthropic activities. Hence, even if the firms can achieve long-term financial viability, the various beneficiaries of their diverse philanthropic activities will suffer in the short run.

Corporate philanthropy tends to vary according to the business cycle; the economic downturn has forced many firms across a variety of industries to cut back not only on direct charitable contributions, but also on employee matching and volunteer programs.[35] GM spokesperson Geri Lama notes that "the current business conditions have resulted in the GM Foundation eliminating, and in some cases significantly reducing, its contributions to many deserving organizations and causes. However, GM and the GM Foundation will continue to show support for our communities and institutions when and how [they] can."[36] Already, the GM Foundation has announced that it will cut over $1 million from its donations to Detroit cultural institutions, including the Detroit Institute of Arts, the Detroit Symphony, the Music Hall, and the Michigan Opera Theatre.[37] In general, the uncertainty about economic conditions makes it hard for firms to predict the extent to which they will be able to sustain their philanthropic activities through the end of the year; however, it is safe to say that further reductions in corporate donations to charitable causes are forthcoming, and not just from the Big Three.

> **"Corporate philanthropy tends to vary according to the business cycle."**

Firms are not the only ones that will reduce their charitable spending. Individuals also are likely to donate less to nonprofit organizations than they did in the past. Clearly, individuals who lose their jobs generally will face tighter budgets and reduce their donations substantially. Even

32 Banjo, Shelley, "Next Benefit to Face the Ax: Matching Gifts." *The Wall Street Journal*, January 14, 2009.
33 Ford Motor Company Fund, "2007 Annual Report."
34 The Chrysler Foundation, "2007 Annual Report."
35 Banjo, "Next Benefit to Face the Ax."
36 Ibid.
37 Associated Press, "GM Foundation Cuts Aid to Detroit Arts Groups." January 7, 2009.

for those who retain their jobs, though, the higher risk of unemployment and the general uncertainty about future economic conditions will increase saving rates. This reduction in individual contributions will depress the nonprofit sector even further.

Endowments are a third channel through which economic conditions affect philanthropic activities. Poor performance of the financial markets, which typically accompanies an economic downturn, seriously hurts investors' portfolios, including nonprofit organizations' endowments. Naturally, given that nonprofits use these endowments to fund their activities, their budgets will become even tighter.

> **"Firms are not the only ones that will reduce their charitable spending. Individuals also are likely to donate less to nonprofit organizations than they did in the past."**

Paul Brest (president, the William and Flora Hewlett Foundation) sees a reason for optimism. He believes that the current figures (1.6 million U.S. nonprofits, which together employ 9% of American workers) point to an inefficient sector: many nonprofits, according to him, are redundant and are not realizing economies of scale, although opportunities for doing so exist.[38] Brest notes that difficult times could promote collaboration among the sector's members, perhaps leading to permanent beneficial changes. Neither Brest nor Vartan Gregorian (president, Carnegie Corporation), however, believes that such changes are especially likely to occur, given the sector's strong inertia. That is not to say, however, that the government cannot provide incentives for such efficiency gains.

38 Economist.com, "A Giving Recession?" January 6, 2009.

POLICY RECOMMENDATIONS

In this section we use the insights gained from the previous sections to define some guiding principles that should influence the government's policy. After defining these principles, we make policy recommendations to President Obama and to Congress.

The issue of the government's proper role vis-à-vis the Big Three has sparked enough debate that only one fact is certain: no consensus exists about the social welfare consequences of government inaction. Sachs and others argue that the public stigma associated with Chapter 11 bankruptcy will hurt demand for Big Three manufactured vehicles, whereas Heritage Foundation analysts believe that Chapter 11 will cause no further damage than the negative publicity already has. A major source of disagreement is the question of whether government aid really will facilitate restructuring and promote long-term financial viability. Unfortunately, it is impossible to know the answer to this question without following a trial-and-error approach.

The provision of a small amount of short-term funding will achieve the following:

- At least temporarily, it will save the firms from collapse and allow them to begin restructuring.
- It will allow policymakers to observe the results of the firms' restructuring efforts and infer whether long-term financial viability – perhaps with additional aid – is achievable.
- It will limit the impact to the government's deficit (and taxpayers' burden) in case the firms eventually do fail.

The Bush administration took this step in December 2008. A series of similar steps, each of which requires the firms to meet stricter benchmarks than the previous one, would be part of a sensible approach for the Obama administration and Congress to employ in steering the Big Three back to profitability.

> **"No consensus exists about the social welfare consequences of government inaction."**

Regarding the need to eliminate the foreign automakers' competitive advantage, Congress must continue to include the UAW in its discussions with the Big Three. It would be utterly fruitless for Congress to set cost-cutting milestones that the firms cannot achieve because of disagreements with the UAW. Furthermore, if there are institutional restrictions that will prevent the Big Three from competing with foreign automakers, Congress needs to work to lessen, if not remove, those hurdles. Possible examples of such restrictions include labor laws, tariffs, and exchange rate manipulation by foreign governments. A significant restriction is the current healthcare system. As we have mentioned, rising healthcare costs are a major concern, and the ramifications extend far beyond the automotive industry. While establishing a universal healthcare program would make the Big Three more competitive vis-à-vis their foreign rivals and likely would be welcomed by the UAW, the pressing need is to address the overall cost of healthcare.

The Johnson Foundation report identifies technological advancement as the primary factor behind rising healthcare costs.[39] Obviously, advancements in medical technology improve social welfare. But it is difficult to compare the benefits of such advancements with their costs. The report mentions that new medical technologies often become widely adopted before their effectiveness and applicability to different types of patients is well understood. Although this fact is troubling, adopting more stringent requirements related to determining the new technologies' effectiveness and applicability will not suffice: efficiency also must be rewarded. Researchers need incentives not only to make discoveries that save lives, but also for developing solutions that save resources.

> **"Researchers need incentives not only to make discoveries that save lives, but also for developing solutions that save resources."**

The report also notes that the payment provider system is problematic: payments are not always correlated with costs, and so healthcare providers have incentives to promote the most profitable services, which often use the newest technologies. As the report points out, having consumers share some of the healthcare costs (and making available to them information on treatment effectiveness and cost) would induce them to make efficient choices: they will balance the quality-of-life benefits of various technologies against their financial costs. The report also lists rising obesity rates as a key factor behind rising healthcare costs. In most cases, obesity is preventable – even curable – through lifestyle changes. Other behaviors that most likely contribute to rising healthcare costs include smoking, drunk driving, and drug abuse. Incentives related to health and fitness may be helpful as part of a long-term strategy for controlling these costs.

The nonprofit sector, unfortunately, is likely to suffer regardless of whether the Big Three achieve financial viability. Just how much it is affected, however, will vary according to the downturn's severity. Thus, the government will serve the interests of this sector by acting to limit the downturn's severity, which includes helping the Big Three achieve profitability. In addition, some provisions for this sector can be incorporated into the American Recovery and Reinvestment Plan, the text of which already includes references to nonprofits. An opinion piece published by the Washington-based Brookings Institution discusses the possibility of using 10% of the stimulus package funds to promote nonprofit activities.[40] The author notes that this sector has a sizable total employment and is both quick and efficient in spending virtually all of the money it receives. In economic terms, it has a high spending multiplier. Given these facts, a severe contraction in this sector would only worsen the situation; it therefore makes sense for the government to try to mitigate such a contraction. At the same time, the government can try to promote greater efficiency – a need that Paul Brest has highlighted – by providing financial incentives for those nonprofits that demonstrate productivity gains. In addition, some provisions for this sector can be drawn from the

39 Ginsburg, "High and Rising Health Care Costs."

40 Sawhill, Isabel V., "Don't Forget the Human Infrastructure." Brookings Opinion, December 22, 2008.

funds allocated to the American Recovery and Reinvestment Act of 2009, the text of which includes references to nonprofits.

Finally, many analysts – including Sachs, Zandi, and Morici – have noted that restructuring presents an opportunity to develop cars that meet higher standards for fuel economy and emissions levels. While this goal enjoys support from many parties (and is important for a number of reasons, ranging from environmental concerns to national security considerations), it needs to be balanced against the objective of helping the automakers achieve profitability. Heavy corporate investment in developing "cleaner and greener" technologies will pay off only if sufficient consumer demand exists for the vehicles that include those technologies. Therefore, in times of declining aggregate consumer demand, these expensive research and development tasks would be better left to nonprofit research labs. On a related note, government standards for fuel economy and emissions (which will affect consumer demand) should be progressive but realistic, given the technological and financial constraints that automakers face. In particular, as Forbes columnist Jerry Flint noted in a recent column, allowing different states (e.g., California) to have stricter standards than other states substantially raises production costs in an industry that is, by nature, one of mass production.[41]

Based on the principles described above, we recommend the following action steps:

SEVEN ACTION STEPS FOR PRESIDENT OBAMA:

1. Continue with former President Bush's plan for helping the Big Three achieve financial viability.

2. Win the support of Congress for follow-up steps to Bush's plan:
   - Firms will be eligible to receive small increments of aid (based on demonstrated need) only if they meet concrete and reasonable milestones that will be set after each disbursement of funds.
   - Milestones should include specific and verifiable conditions that relate to both of the following criteria:
     - » Solvency
     - » Increasing competitiveness with Toyota, Honda, and Nissan
   - Milestones must be approved by Congress, executives of the Big Three, and the UAW.

3. Engage the Department of Energy in the following:
   - Provide additional funding for developing technologies that will improve automobile fuel economy and reduce emissions at reasonable costs.
   - Develop reasonable national standards, which can be adjusted based on technological progress, for automobiles.

41 Flint, Jerry, "What Detroit Needs from Washington." Forbes.com, January 26, 2009.

4. Engage the Department of Health and Human Services in researching and evaluating the following:
   - Means of measuring effectiveness and cost for advancements in medical technology.
   - Availability of effectiveness and cost information to consumers of healthcare services.
   - Federal incentives for cost-saving advancements in medical research and medical technology development.
   - Existing procedures by which new medical technologies take hold and old ones are "phased out."
   - Healthcare provider payment systems and procedures.

5. Consider possibilities for raising health awareness and promoting healthful lifestyles among Americans:
   - Financial incentives for firms that subsidize fitness center memberships for their employees.
   - Advertisement campaigns related to exercise, sensible eating, smoking, drunk driving, drug abuse, and other health-related behaviors.

6. Encourage Congress to earmark a reasonable amount of funds to support the activities of nonprofits, particularly:
   - Those whose activities will help lower healthcare costs.
   - Those that realize efficiency gains.

7. Appoint a task force to investigate further options for healthcare reform, including the possibility of a universal healthcare system.

SEVEN ACTION STEPS FOR MEMBERS OF CONGRESS:

1. Set aside ideological differences and evaluate proposed policies based on their economic costs and benefits.

2. Work with President Obama, and each other, in implementing economic policies that make sense for both businesses and taxpayers.

3. Negotiate aid conditions with the Big Three and the UAW in good faith.

4. Assemble an independent panel of experts to assess the automakers' progress in achieving their milestones.

5. Investigate and work to remove any disadvantages that existing institutional conditions (e.g., labor legislation, tariffs, and exchange rate manipulation) may unfairly impose upon the Big Three and other American firms that face growing foreign competition.

6. Work with the Obama administration to develop national standards for automobiles.

7. Work with the Obama administration to explore and implement healthcare reform options.

CONCLUSION

The above policy recommendations share a noteworthy feature: they call for cooperation among the Obama administration, members of Congress, the Big Three executives, and the UAW leaders. Perhaps more than anything else, cooperation among experts, policymakers, and stakeholders is needed to stabilize the floundering U.S. economy. Cooperation often entails difficult choices and sacrifices, and the current conditions certainly will require several extremely difficult choices and sacrifices for a number of people.

The situation that we face calls for concerted action by firms, the government, and even taxpayers. Some commentators will, no doubt, express alarm over the government's bailout and economic stimulus packages and its increased involvement in the healthcare system; they will warn us of a growing trend toward the nationalization of private industry and the establishment of a welfare state or socialist regime. And perhaps we need such voices to prevent matters from getting out of hand. But at this time, the circumstances and the potential consequences are such that experts, policymakers, and stakeholders need to set aside their ideological differences and work together to promote the single interest that they all share: the welfare of the American people.

INSTITUTE FOR SOCIAL POLICY AND UNDERSTANDING

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