AIER | Research Reports

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Pensions at Risk: A Perfect Storm?

The Big Three's woes combined with a federal agency' s mistimed shift in investment strategy could lead to another big bill for taxpayers.

by R.D. Norton, AIER Senior Fellow

As GM and Chrysler flirt with bankruptcy, what about the pensions the companies have promised their workers? A central issue is whether taxpayers might have to cover the obligation—a bill that for GM alone is estimated at $13.5 billion.

The Big Three automakers' retiree health benefits are not insured by anybody and conceivably could be scrapped. Once they reach age 65, retired workers would have to rely on Medicare.

But the government does guarantee autoworker pensions, which are insured for as much as $54,000 a year.

Though still common in the public sector, defined-benefit pensions exist today in the private sector mainly in heavily unionized industries. The Big Three automakers are the poster boys for such generous pensions.

Generous pensions and retiree health insurance on the part of the Big Three automakers can be traced back to a 1950 accord between the companies and the United Auto Workers under Walter Reuther. He actually wanted government to provide pensions and retiree health care, but the car companies saw it differently.

As the accompanying box explains, Detroit initially found it easy and inexpensive to make lavish promises to workers who would not retire until decades later.

Just as a struggling bank may 'take a flyer' on a high-risk investment to put itself back in the black, Penny Benny placed a big bet and lost.

A bankrupt car company then turned out to provide the impetus for government pension guarantees. In 1963 Studebaker went out of business. Its retired workers got only about 15 cents on the dollar of their promised pensions. Although it took a decade, Congress eventually got around to trying to fill in the safety net for private-sector retirees in the Employee Retirement Income Security Act (ERISA).

This 1974 law set up a low-profile governmental agency, the Pension Benefit Guaranty Corporation. Its ungainly acronym, PBGC, gave rise to the moniker, Penny Benny.

Penny Benny's job is to insure the traditional, defined-benefit pensions of workers whose employers go broke or otherwise come up short. Its website cites a figure of 44 million workers and retirees it protects.

Earlier this decade, several large airlines and steel companies declared bankruptcy and turned their pension obligations over to

AIER | May 2009 Business-Cycle Conditions

The current recession is shaping up to be one of the worst in postwar history: The unemployment rate hit 8.5 percent in March, new home construction is at very low levels, and the volume of loans is continuing to shrink.

See our Business-Cycle Conditions section inside for AIER's detailed analysis.

Percentage of AIER Leaders Expanding

17

unchanged

the PBGC. Among them, Delta, United, and US Airways are still in operation. As a matter of some controversy, such traditional airlines have reorganized under the protection of bankruptcy, a balancing act that might include stretching out loan payments—and unloading costly pension and medical benefits.

The typical scenario finds a company like United Airlines going into bankruptcy and unloading its pension obligations on Penny Benny. The agency then salvages whatever assets it can from United's pension funds and uses the proceeds to help make good on the commitment to United's present and future retirees.

To date, general revenues have not been used for PBGC pension payments. Instead, the agency uses funds from investment earnings, assets it recovers from failed companies, and insurance premiums (currently $33 per worker) collected from companies with defined-benefit pension plans. In fiscal 2008, the insurance premiums brought in $1.5 billion.

At the end of the 2008 fiscal year, the agency had liabilities of $72.3 billion and assets of $61.6 billion, which created a deficit of $10.7 billion.

The deficit has no immediate urgency, but instead represents an accounting imbalance that must eventually be rectified.

But last year Penny Benny's then director, Charles E.F. Millard, seems to have panicked. Just as a struggling bank may "take a flier" on a high-risk investment to put itself back in the black, Penny Benny placed a big bet and lost.

Against the advice of both the Congressional Budget Office and the General Accountability Office, Mr. Millard decided that the only way to close the gap was to get into riskier investments. His reasoning: Higher risk is correlated with

Continued on page 3

Top 10 Firms Presenting Claims (1975-2007)
PBGC Single-Employer Program

	Fiscal Year(s) of Plan Terminations	*Claims (by firm)*	*Vested Participants*	*Percent of Total Claims*
1. United Airlines	2005	$7,503,711,171	122,541	21.5%
2. Bethlehem Steel	2003	3,654,380,116	91,312	10.5%
3. US Airways	2003-5	2,684,542,754	57,002	7.7%
4. LTV Steel	2002-4	2,134,985,884	83,094	6.1%
5. Delta Air Lines	2006	1,740,482,711	13,028	5.0%
6. National Steel	2003	1,275,628,286	33,737	3.7%
7. Pan American Airlines	1991-2	841,082,434	31,999	2.4%
8. Trans World Airlines	2001	668,377,106	32,275	1.9%
9. Weirton Steel	2004	640,480,970	9,410	1.8%
10. Kaiser Aluminum	2004-7	602,132,764	18,402	1.7%
Top 10 Total		$21,745,804,196	492,800	62.2%
All Other Total		13,193,241,357	1,087,787	37.8%
TOTAL		$34,939,045,553	1,508,587	100.0%

Source: Congressional testimony, Charles E.F. Millard, Director, PBGC, October 24, 2008.

The Origins of the Big Three Handicap

Back in 1950, when the U.S. was the last economy standing after the war and auto workers were young and healthy, GM said, in effect: Let's keep wage gains moderate—but we'll throw in some generous pensions and medical insurance. The result at the time has been called a "free lunch," because it was easy to give the UAW these promises of future gains, while leaving current profits (and GM's stock price) high.

Ford and Chrysler quickly followed GM's lead. Across the board, retirement and health insurance burdens remained insignificant, because the number of retirees was small, relative to current workers.

Over the decades, of course, the free lunch became a very expensive proposition. By the end of the century, GM had twice as many retired as current workers. The pension and post-retirement health insurance costs have come to add $2,000 on average to the price of GM cars. (By comparison, the amount is about $700 for the Toyota plants operating in the U.S.)

To keep prices competitive, GM (and Ford and Chrysler) had to cut back on something—and that turned out to be research and development. So while Japanese and German cars continued a relentless dynamic of quality improvements and new designs over the years, Detroit settled for gas-guzzling SUVs and pick-up trucks.

The result, according to the April 2009 *Consumer Reports* ratings of the world's 15 largest car companies: All four of the top-rated companies are Japanese, while Detroit's Big Three (especially GM and Chrysler) are relegated to the bottom of the list.

Hence the question. How would continuing bailouts help persuade Americans to buy Chrysler and GM's products, when the quality remains in doubt? That is the underlying issue, and it has brought GM and Chrysler to the brink of bankruptcy.

AIER | Business-Cycle Conditions, May 2009

Faint Glimmers in the Dark

While the data show no clear signs of recovery, some at least provide mixed signals. The hope is that painful adjustments will hasten a turnaround.

by Polina Vlasenko, AIER Research Fellow

The current recession is shaping up to be one of the worst in postwar history. Our recent data show no clear signs of improvement of business-cycle conditions. And they do not yet reflect the planned layoffs by Detroit automakers or their possible bankruptcies.

The employment situation continues to worsen. The unemployment rate reached 8.5 percent in March. The *average workweek in manufacturing* has been falling for 12 months and currently stands at 39.3 hours. *Initial claims for state unemployment insurance* increased for the 14th month in March. The *average duration of unemployment* also increased again. (Since the government substantially lengthened the period for which unemployment benefits are paid, average duration can be expected to increase further.)

While our primary leading indicators do not suggest a recovery, the data provide some mixed signals. *New housing permits* fell again in March, establishing a new postwar low. But there are now signs that the reduction in new housing construction could bear fruit: The inventory of unsold *new* homes is shrinking. According to the U.S. Census Bureau, the number of unsold new single-family homes fell from 328,000 in February to 311,000 in March. This represents a 10.7-month supply at the

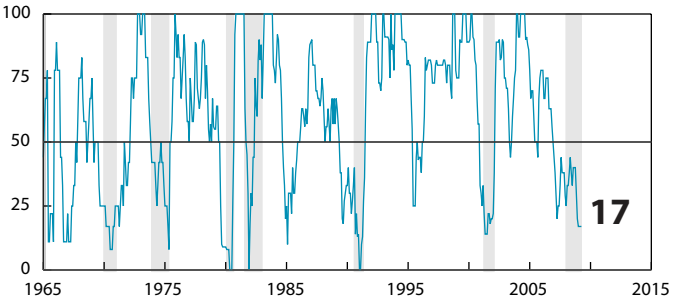
Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Dec.	*Jan.*	*Feb.*	*Mar.*	***Primary Leading Indicators***	*Feb.*	*Mar.*	*Apr.*
+	-	-	+	M1 money supply	+	+	+
+	+	+	+	Yield curve index	+	+	+
-	+	nc	+	Manufacturers' supply prices	-	-	-?
-	-	+		New orders, cons. goods	-	-	-
-	-	+		New orders, core cap. goods	-	-	-
-	-	+	-	New housing permits	-	-	-
-	-			Ratio of mfg. & trade sales to inv.	-	-	-
-	-	+	-	Vendor performance	-	-	-
+	-	-	-	Index of common stock prices	-	-	-
-	-	-	-	Average workweek, mfg.	-	-	-
-r	-	-	-	Initial claims, unempl. ins.	-	-	-
-	+	+		Change in consumer debt	-	-	-
				Percentage expanding cyclically	*17*	*17*	*17*
				Primary Roughly Coincident Indicators			
-	-	-	-	Nonag. employment	-	-	-
-	-	-	-	Index of industrial production	-	-	-
-	-	-		Pers. inc. less transfer payments	-?	-?	-
-	-			Manufacturing and trade sales	-	-	-
-	-	-	-	Civilian emp. to pop. ratio	-	-	-
-	-	-	-	Gross domestic product	-	-	-
				Percentage expanding cyclically	*0*	*0*	*0*
				Primary Lagging Indicators			
-	-	nc	-	Avg. duration of unemployment	-	-	-
-	-			Manufacturing & trade inventories	-?	-	-
-	-	-		Commercial & industrial loans	+	+?	?
+r	+r	-		Ratio of cons. debt to pers. inc.	?	?	?
+				Chg. in labor cost/output, mfg.	+	+	+
-	-	+	-	Short-term interest rates	-	-	-
				Percentage expanding cyclically	*40*	*40*	*25*

nc No change. r Revised. Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

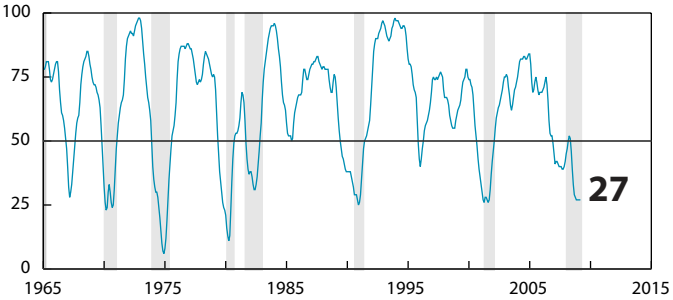
AIER Leaders Expanding and Cyclical Score Charts

Percentage of AIER Leaders Expanding



The percentage of leaders expanding is based on the analysis of 12 statistical series that move reliably in advance of general business activity. The cyclical score is based on a separate, purely mathematical analysis. For each measure, a score below 50 indicates a contraction is likely.

Cyclical Score of AIER Leaders



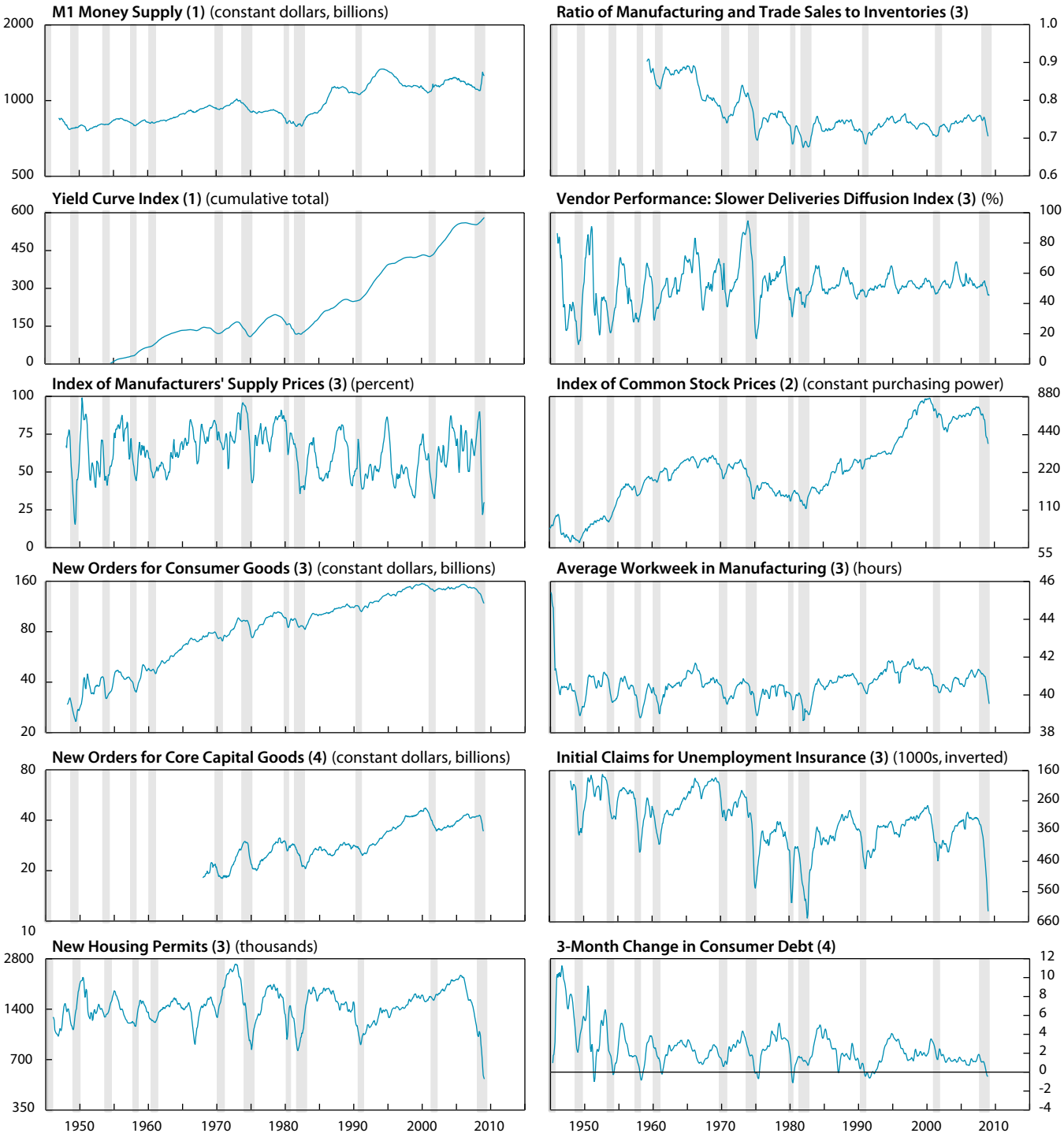
current sales rate, well below the peak of 12.5 months reached in January.

New homes are only a part of the story: Existing homes comprise 85 percent of the market. According to the National Association of Realtors (NAR), inventories of existing homes for sale declined by 1.7 percent in March to 3.74 million homes. This represents a 9.8-month supply, noticeably below the 11-month supply at the end of 2008.

The inventory of homes for sale, both new and existing, needs to fall to a 7- to 8-month supply to bring about house price stabilization, says the NAR. So, while recent trends are encouraging, it will take some time for the inventory to reach normal levels.

Although the stock market recently rallied to create a 20 percent increase, our analysis only includes data

Primary Leading Indicators



through March. The *index of common stock prices* (constant purchasing power) decreased in March.

Another measure of the current economic climate is continued claims for unemployment insurance, which represent the total number of people receiving unemployment insurance payments. It recently surpassed 6 million for the first time in the postwar period. However, since the labor force increases over time, this number should be put in perspective.

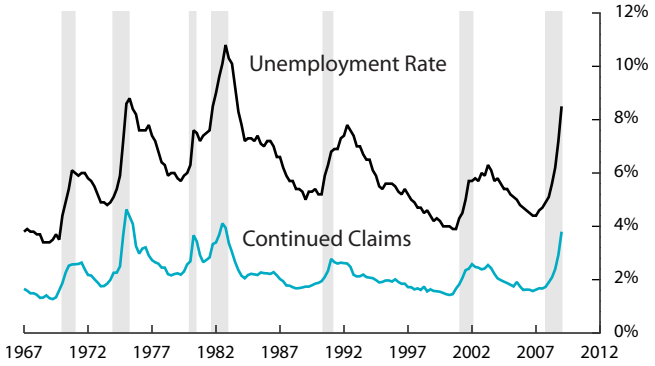
The chart at right shows continued claims as a fraction of the labor force. This series differs from the unemployment rate (also shown) because not all unemployed people receive unemployment insurance payments. The increase in continued claims since the beginning of 2008 is dramatic. But the current level of 3.8 percent of the labor force does not quite match the levels seen in the 1981-82 or 1973-75 recessions.

The chart also shows the difference between the unemployment rate and the percentage of people receiving unemployment benefits. In March, 4.7 percent of the labor force was unemployed but not receiving benefits. The current percentage of workers experiencing the full pain of unemployment is below the 5.2 percent seen following the 1991 recession. And it is substantially smaller than the 6.8-7 percent seen in 1982.

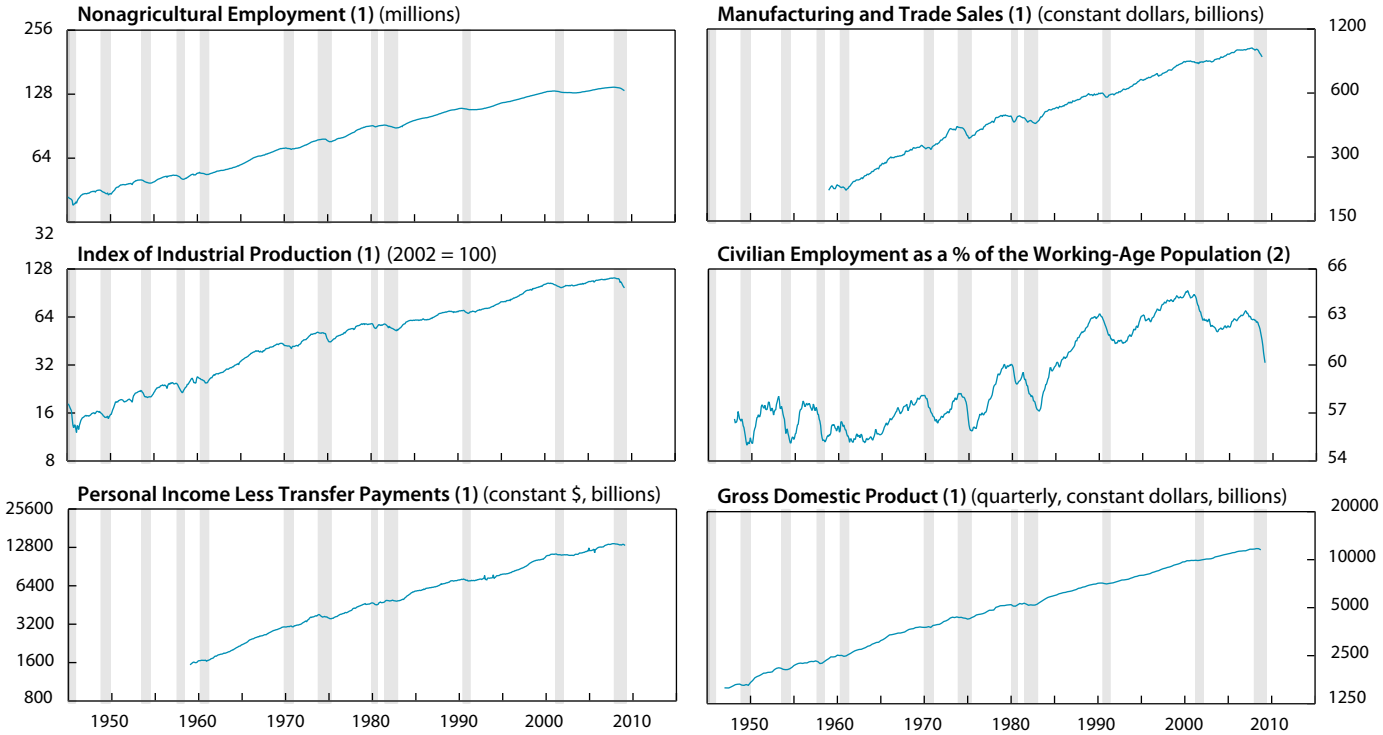
Overall, for the leading indicators, the picture is little changed from last month. We changed the appraisal of one leader. The *index of manufacturers' supply prices* increased in March, following an increase in January and no change in February. This might indicate a slowing of the downward trend, and we changed the appraisal from clearly to probably contracting. This did not affect the percentage of leaders expanding.

New orders for consumer goods and *new orders for core capital goods* both increased in February, for the first time since June 2008. The one-month increase, however, is not enough to indicate a new trend. Both series remain

Unemployment and Continued Claims as Percentage of Labor Force

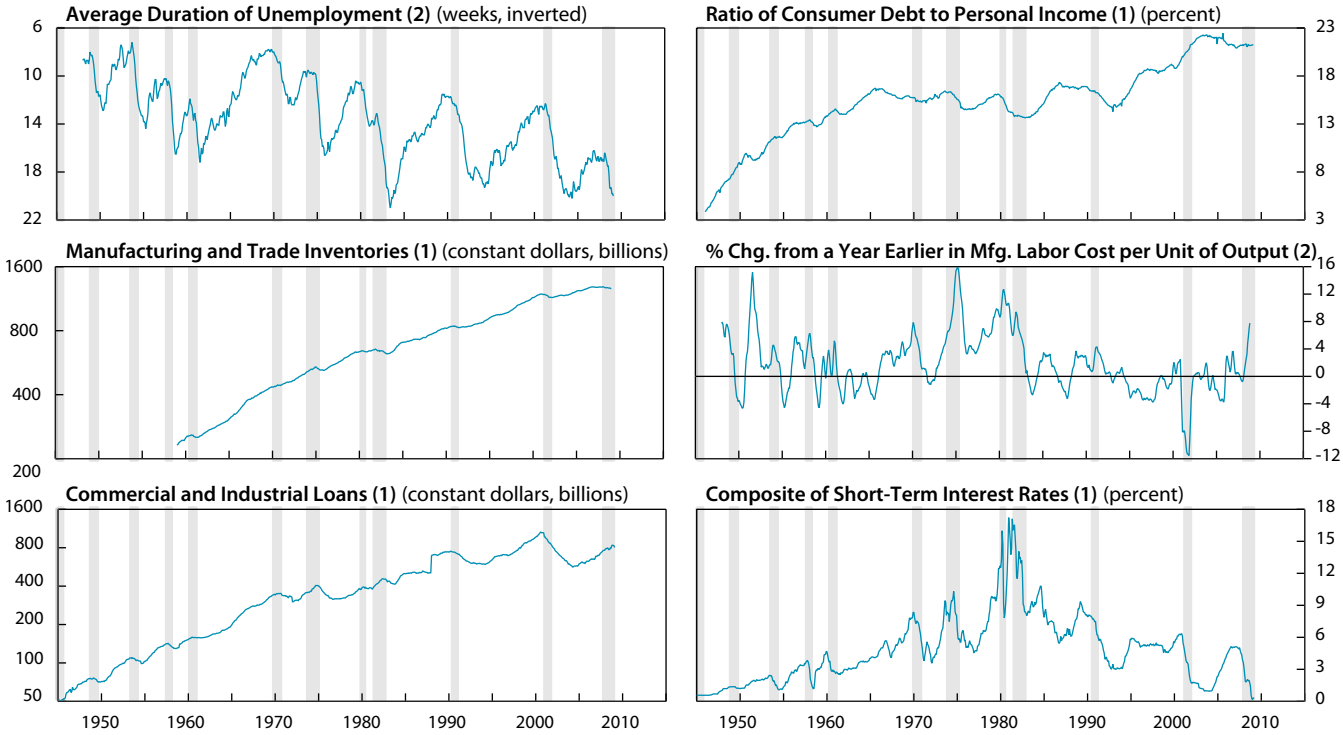


Primary Roughly Coincident Indicators



Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.

Primary Lagging Indicators



appraised as contracting.

The percentage of primary leading indicators appraised as expanding remains at 17 for the fourth month in a row. The cyclical score, which is based on a separate, purely mathematical analysis, fell to 27 from 28 last month. For all our measures, a level below 50 indicates that a contraction is more likely than an expansion.

All roughly coincident indicators are appraised as clearly contracting. We downgraded the appraisal of *personal income less transfer payments* to clearly contracting: The series has declined for so many months, the cyclical score hit zero.

Labor costs were even higher relative to output than we originally thought. These costs are the reason why many firms face the need for drastic layoffs.

The constant-dollar *gross domestic product* decreased at an annual rate of 6.1 percent in the first quarter of 2009, according to the advance estimates released by the Bureau of Economic Analysis (BEA). This is smaller than the 6.3 percent decrease in the fourth quarter of 2008, but it still represents a substantial contraction. The BEA emphasizes that the advance estimates are subject to revisions, sometimes substantial ones.

The *index of industrial production* has declined for the fifth straight month and currently stands at 97.4. This means that the volume of goods produced by manufacturing, mining, and electric and gas utilities in March was below its average in 2002, the base year of the index.

The cyclical score of the coinciders fell to two, the lowest postwar reading. The coinciders strongly confirm that the economy is in recession.

Among the primary lagging indicators, we downgraded one series. *Commercial and industrial loans* decreased for the third straight month in February and is now appraised as indeterminate. This change brought the percentage of laggers expanding to 25 (one out of four series with a discernable trend), down from 40 last month.

Recently, there have been several reports of firms, besides the automakers, planning further layoffs, indicating that businesses are making significant adjustments in response to the economic situation. As tighter lending standards drive down the volume of commercial and industrial loans, businesses can no longer afford to wait for economy to improve. They have to lay off workers to reduce costs.

While we have no new data on the *change in labor cost per unit of output (manufacturing)*, the existing data for October, November, and December have been revised upward. Labor costs were even higher relative to output than we originally thought. These costs are the reason why many firms face the need for drastic layoffs. A turnaround in labor cost per unit of output would be an encouraging sign of economic recovery. The hope is that the layoffs, while painful in the short run, will hasten the adjustment and bring about the recovery.

Continued from page 2

higher returns in the long run.

As the chart shows, three-quarters of Penny Benny's investment portfolio targets had until then been in long-term bonds, both corporate and Treasuries. These are safe if unexciting investments, yielding commensurately low rates of return.

The new, more aggressive allocation targeted 39 percent into U.S. and foreign stocks, and another 25 percent into more exotic assets—real estate, private equity, and junk bonds (also known as "high-yield fixed income").

Unfortunately, the agency shifted gears at exactly the wrong time. As the Boston *Globe* pointed out recently, just as Penny Benny implemented the move into stocks, the stock market plummeted—even more sharply abroad than here.

In sum, the September strategic shift had a head-on collision with the October rout.

How big a loss resulted for the PBGC? It's a secret. Penny Benny, even under a new director, is not telling. Director Millard has moved on, resigning January 20, with the changing of the guard. In his view, the agency made no mistake, even though it will take decades of "fortitude" to stay the course with the high-risk strategy.

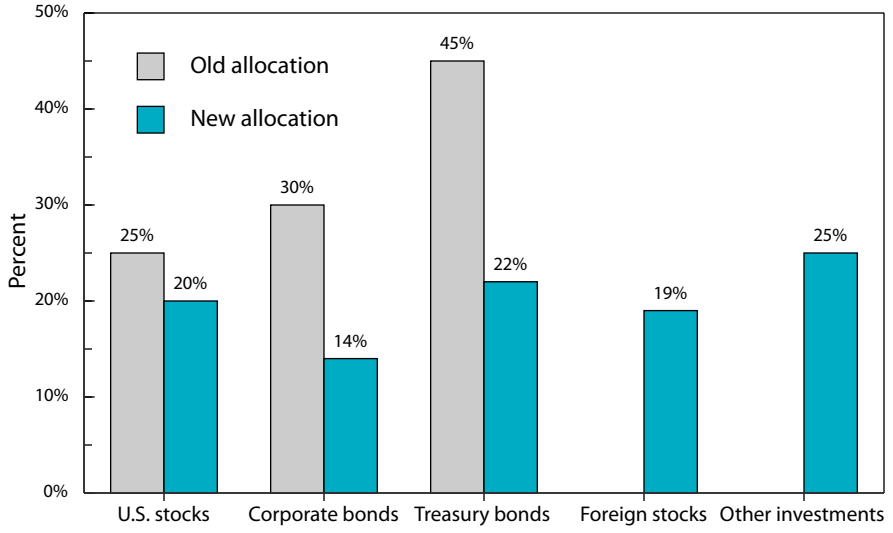
The new director is Vincent Snowbarger. He says that whatever the nature of the bankruptcies GM and Chrysler may go through, Penny Benny wants no part of their pension obligations. As he puts it, "…just because a company goes into bankruptcy doesn't mean that they terminate their pension plan."

He points out that Penny Benny has recently worked with the dozen or so auto suppliers that were in bankruptcy but that came out of it with intact pension plans.

The upshot? This is not a good time for GM or Chrysler to unload their pension obligations onto Penny Benny.

Otherwise, the strain on the PBGC could well lead to another huge bill for taxpayers. That would mean in practice that millions of people with no prospect of pensions of their own would wind up paying higher taxes to maintain pension benefits for autoworkers. As we saw with the taxpayer-financed million-dollar bonuses going to AIG executives, such distortions are no longer welcome.

Changes in PBGC Target Portfolios in 2008



Note: "Other investments" include real estate (6 percent), private equity (5), TIPS (4), emerging market debt (3), and high-yield fixed income (2).
Source: Michael Kranish, "Pension Insurer Shifted to Stocks," *Boston Globe*, March 30, 2009.

Ask the Expert

Evaluating Elderly Housing

Determining the financial stability of a retirement community or assisted-living facility is one of the first things you must do when considering a move for yourself or a family member. Ask the facility for a financial statement as well as financial projections for the future. Any legitimate company will have no problem providing you with this information. Take it to an accountant or other financial professional who can determine the stability and financial soundness of the institution.

Although the federal government does not regulate independent-living facilities and assisted-living facilities, the nongovernmental Joint Commission on Accreditation of Healthcare Organizations evaluates and accredits assisted-living facilities. There is much helpful information on their website, www.jcaho.org.

Another good source of information is your state's long-term care ombudsman. Each state has one, and you don't even have to be able to pronounce the word to be able to avail yourself of this person's services. Your state's ombudsman might also be able to assist you in locating inspection reports and records of complaints that have been lodged against the facilities that you are considering. An easy place to find your state's long-term care ombudsman is www.ltcombudsman.org.

You also would be wise to consult with an experienced elder law attorney who will be familiar with issues surrounding the protection of any entry fees and other requirements of the particular facilities.

—Steven J.J. Weisman is a lawyer and author. His website is www.stevelaw.net.

To submit questions for future columns, email asktheexpert@aier.org. For guidance on specific situations, consult your lawyer or financial advisor.

Private Lives, Public Objectives

Government policies often define families in contradictory ways. But a larger problem may be the inherent invasion of privacy implicit in those definitions.

by J. Eric Smith

Most Americans view the family as the nation's most basic social unit. Threats to its integrity and privacy often serve as rallying cries. Conservatives tout the erosion of family values. Liberals decry the burdens placed upon working families. Citizens of all political inclinations wrestle with the ramifications of same-sex marriages. At the heart of these debates lies the question: How does the government define what counts as a family?

Patricia Strach writes in her 2007 book, *All in the Family: The Private Roots of American Public Policy* (Stanford University Press, $20.95, paperback) that the government has many definitions of family, and often uses them to conscript private citizens into a shadow bureaucracy organized to satisfy policy objectives. Lawmakers may use families to implement their agendas in three ways.

1. Using family as criterion of eligibility. Definitions of family members have been crucial tools in expanding or contracting immigration policy. Between 1952 and 2002, the definition of "child" in immigration law changed 12 times, and there were 29 changes to the law affecting criterion of eligibility for family members. Some of these definitions are arbitrary and potentially contradictory. Illegitimate children of citizen mothers, for example, have unconditional standing in immigration matters. Illegitimate children of citizen fathers have standing only provided they can prove a *bona fide* parent-child relationship. Adult parents of naturalized citizens are eligible to immigrate as related family members of their citizen children. Adult parents of non-citizens seeking to immigrate are *not* eligible to claim the same priority of preference.

2. Using family as administrators of benefits. The tax code has proven to be an efficient tool for enacting public policy via private families. Consider education. The government provides tax incentives to encourage parents to save for their children's educations. This reduces the potential need for government subsidy, and increases the likelihood that more children will receive college educations. Policy makers do not provide incentives for *any* taxpayer to pay for *any* student's college education, effectively creating a requirement for parents to learn about, fund, administer, and report their children's college savings correctly. When a head of household allocates such incentives for family members, he or she essentially is acting as a policy administrator for the federal government.

3. Using family as a normative ideal. The self-sufficient farmer has long been regarded as a powerful American symbol, and the family farm is an ideal often offered up in contrast to large and impersonal agribusinesses. The reality is that per the formal definition of family farm used by the U.S. Department of Agriculture, family farms don't stand in opposition to corporate farms. Rather, 90 percent of all corporate farms actually *are* family farms. By evoking the ideal of the family farm, policy makers appropriate the experiences and travails of legitimate small landholders to benefit operations that often are in direct opposition to the ideal.

The ways in which human beings can be combined to create families by blood, law, or affection create an inherent tension when public policy is crafted around such combinations.

The ways in which human beings can be combined to create families by blood, law, or affection create an inherent tension when public policy is crafted around such combinations. While the government may achieve efficiencies by doing so, such an approach leads to an obvious question: What happens to the policies when the looks and values of families change? Ultimately, Strach says, such policy making impinges on the lives of Americans by making personal relationships the qualifiers for government goods and services, while allowing only the government to codify the terms by which family is defined.

AIER | gold corner

Price of gold, April 30, 2009, London PM fix.

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