IS GM JUST IN BUSINESS TO PAY THEIR WORKERS' PENSION?

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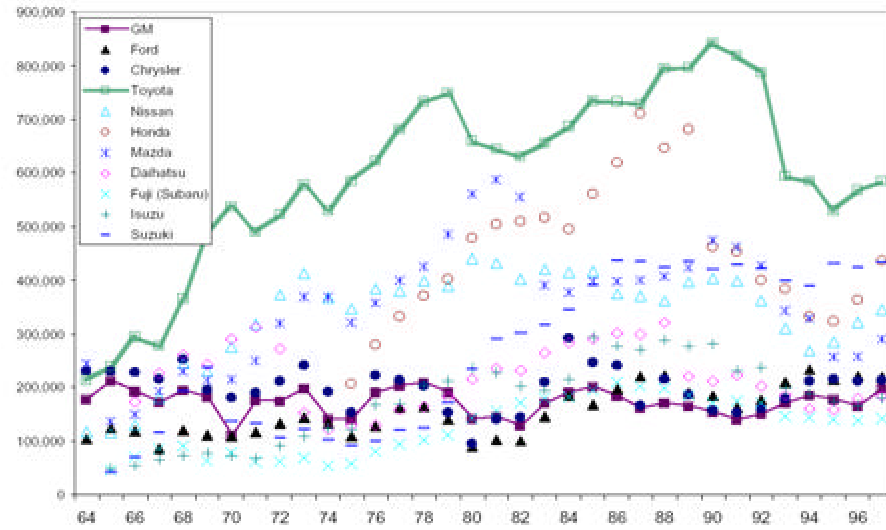
United's successful efforts to get rid of its pension plans to PBGC now opens the way for other floundering corporate titans dealing with their own pension shortfalls. The private sector pension plans are now facing a combined $450 billion in short-falls, and the poster boy right now is GM. GM has also lost three-fourth of its market value, some $43 billion, since the spring of 2000. The carmaker is considered to be saddled with a $1600-per-vehicle handicap in so-called legacy costs, mostly retiree health and pension benefits. Its debt has now been relegated to junk status from a once venerable position of AAA. Talks of GM's bankruptcy are in the air even when its cash position shows more than $44 billion in available liquidity! What is going on here?

GM's agreement with its unions makes it impossible to close plants or lay off workers, no matter what the market conditions dictate. Whether US consumers are shunning its cars or global economic demand is taking a breather, it has to run plants at full capacity. Why this counter-intuitive move by a smart company? Because GM must continue to pay worker salaries and their pension and health benefits. When it shuts down the assembly lines, workers sit idle, and as they are a fixed cost, not a variable one, normal economic rules imply. The optimal solution under these circumstances is to make cars first and worry about selling them later. The solution has arrived in the form of generous cash rebates and financing deals that came into play after 9/11, aided to a large extent by the super-low interest rates. GM, and Ford too, were actually making money from their financing arms and subsidizing the money-losing assembly line production. That gravy train is over now since the FED started raising rates last summer. Now, there isn't enough profit available from their financing arms to pay for all the promises made to workers in the production arm, some of which were ridiculous, such as no co-payments for health plans.

What's the prognosis? A Wall Street Journal op-ed piece called GM the social security bank of the unions! The government may step in to keep the company going as it won't allow it to dump its pension plans on the PBGC, which itself is under-funded. GM will continue to produce cars to keep servicing its pension plans. I am about to publish a paper



Source: Dhawan and Lieberman (2002), forthcoming in *Management Science*

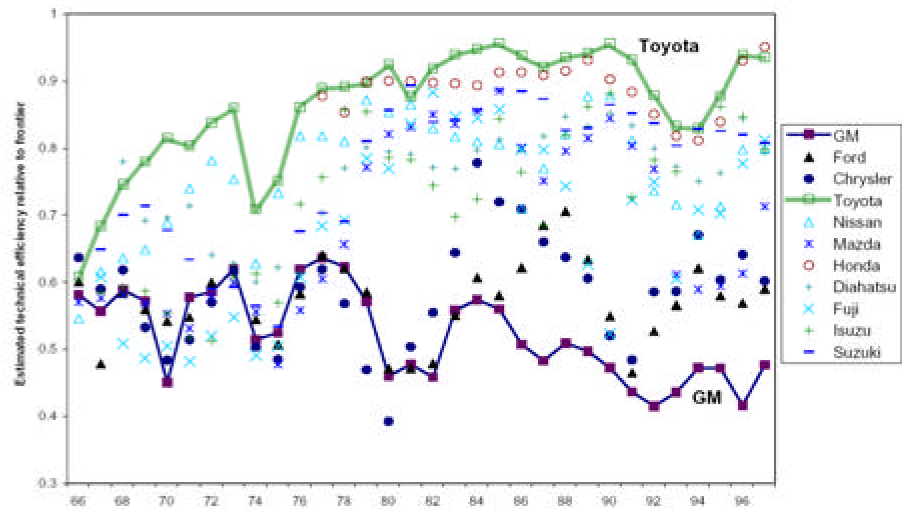
in the *Management Science* journal with my co-author Marvin Lieberman of UCLA that measures the efficiency of automakers in US and Japan. People in the media, and even the academic literature, is fixated on the concept of market share. Bigger is better, higher market share will do the trick for GM, stop losing market share to the Japanese, etc., etc., is all the talk these days. That may work from the marketing perspective, but when it comes to the real metric of productivity, such as volume per unit of a plant, GM lags far behind Toyota (see Figure A). Toyota, incidentally, is only one-tenth the size of GM when measured in terms of its number of employees.

We statistically estimated a metric called technical efficiency of a firm, which measures the deviation of a firm from its production frontier. We found that the higher the deviation from the frontier (i.e. the lower the output for the same level of inputs), the lower the technical efficiency of the firm. By this metric, as you can see in Figure B, Toyota defines efficiency standards in the auto industry. GM and Toyota started off at an almost equal footing in 1966 when their efficiency measures were at 60%. But by 1998, Toyota was at 90% plus efficiency levels, whereas GM is only at 50%, a huge productivity differential. This is after accounting for factors such as cost of inputs, vertical integration, capital investment per worker, etc.

People say size matters in this business. If so, then how does one explain Honda's performance, which is half the size of Toyota but rivals it in efficiency performance? Simple, you have to be better at managing your inventories by locating suppliers close to your plants. Also known as the just-in-time-inventory method, it was pioneered by Toyota, then adopted by other Japanese companies, and after awhile incorporated by the Big Three. In this respect, Ford and Chrysler were early converts compared to GM, which shows as their efficiency numbers are twenty to forty percent higher than that of GM's.

So in simple words, what is this technical inefficiency? These are factors for which in our regressions we have no quantitative measure-

Figure B. Technical Efficiency by Firm and Year



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ments as explanatory variables. The prime candidate is the quality of management, which includes not only the executives, but production workers' unions as well.

What can GM do to survive? Survive it will, but to do so efficiently, it has to get rid of its current management structure. Unions are not the only culprits. Upper management has taken a short-run approach. They promised workers whatever benefits they wanted when the company was flush with cash in boom times, but then when the financial markets went sour, a pension short-fall occurred. Not that this mattered to the decision-makers-by then they long gone. The strategy: pass on the problem to the next guy if your expected tenure is equal to the attention span of a toddler.

How do we overcome this incentive compatibility problem? The problem is that compensation is based on current performance from current work effort. Very little of it is deferred comp based on long-term performance. I suggest we make upper management take part of their compensation in 30-year company-issued bonds that they cannot easily sell. If later the company goes bankrupt, because you promised too much under your watch, then…Voila! No payouts. This will take care of any time-inconsistency problem, based on short-term actions.

Something like this is also needed in the public sector given that city and state administrations all over the US have promised their workers what they can't afford. The public-pension plan shortfalls are a hidden time-bomb. Any politician foolhardy enough to tackle it, as our own Arnold is trying in California, where the state pension costs are eating up a chunk of the budget, and you get the wrath of unions onto you. But remember, we are talking about Arnold here, not a career-politician, so don't underestimate him the way Saddam underestimated the resolve of Bush to throw him out. There is hope for California yet!