Daniel J. Ikenson
Associate Director, Center for Trade Policy Studies, Cato Institute
July 22, 2009
Ramifications of Auto Industry Bankruptcies, Part III

Testimony of Daniel J. Ikenson
Associate Director, Center for Trade Policy Studies, Cato Institute
Before the U.S. House of Representatives, Judiciary Committee,
Subcommittee on Commercial and Administrative Law

Good morning, Chairman Cohen, Ranking Member Franks and members of the committee. I am Daniel Ikenson, associate director of the Center for Trade Policy Studies at the Cato Institute. Today, I would like to share some general concerns about the ramifications of the auto industry bankruptcies. The views I express are my own and should not be construed as representing any official positions of the Cato Institute.

The Past Eight Months

On November 5, the morning after Election Day 2008, a report was published by the Center for Automotive Research, a Detroit-based consulting firm, warning that three million jobs were at stake in the automotive sector unless the U.S. government acted with dispatch to ensure the continued operation of all of the Big Three automakers.[1] Detroit's media blitz was underway. And it was timed to remind the president-elect, as he contemplated his victory the morning after, of the contribution to his success of interests now seeking some help of their own.

The CAR report's projection of three million job losses was predicated on some fantastical worst case scenario that if one of the Big Three were to go out of business and liquidate, numerous firms in the auto supply chain would go under as well, bringing down the remaining two auto producers, as well as all of the foreign nameplate U.S. producers and, subsequently, the rest of the parts supply chain. Oddly, the report gave no consideration to the more realistic scenario that one or two of the Detroit automakers might turn to Chapter 11 reorganization.

The subsequent public relations effort to make the case for federal assistance was pitched with an air of certitude and immediacy that the only real alternative to massive federal assistance was liquidation and contagion. The crisis-mongering was reminiscent of former-Treasury Secretary Henry Paulson's and Federal Reserve Board Chairman Ben

[1] David Cole, Sean McAlinden, Kristin Dziczek, Debra Maranger Menk, "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers," Center for Automotive Research Memorandum, November 4, 2008, available at http://www.cargroup.org/documents/FINALDetroitThreeContractionImpact_3__001.pdf

Bernanke's insistence six weeks earlier that there was no time for Congress to think, only time for it to act on a financial sector bailout, lest the economy face financial ruin.

The mainstream media obliged the script, elevating the automobile industry "crisis" to the top of the news cycle for the next month, and helping to characterize the debate in the simplistic, polarizing dichotomy of "Main Street versus Wall Street." The notion that some financial institutions took risks, lost big, and were rescued by Washington became the prevailing argument for bailing out the auto companies, and the specific facts about viability and worthiness were tertiary.

But public opinion that was initially accommodating of that characterization quickly changed when the CEOs of GM, Ford, and Chrysler laid waste to months of public relations planning and millions of dollars spent trying to cultivate a winning message when they each arrived in Washington, tin cups in hand, aboard their own corporate jets. That fateful incident turned the media against Detroit and reminded Americans – or at least opened their minds to the prospect – that the automakers were in dire straits because of bad decisions made in the past and helped convince them that a shake out, instead of a bailout, was the proper course of action.

Although legislation to provide funding to the automakers passed in the House of Representatives last December, the bill did not garner enough support in the Senate, where it died. Prospects for any form of taxpayer bailout seemed remote and the proper course of action for GM and Chrysler, reorganization under Chapter 11, appeared imminent. An interventionist bullet, seemingly, had been dodged. But then, just days after then-Secretary Paulson claimed to have no authority to divert funds from the Troubled Assets Relief Program to the auto companies, President Bush announced that he would authorize bridge loans from the TARP of $9.4 billion and $4.0 billion to GM and Chrysler, respectively.

As the companies were incurring $6 billion of operating losses per month at that time, it did not require a Ph.D. in finance to recognize that they would exhaust those funds in a matter of months and be back at the trough. And when they returned – as stipulated in the terms of the loans – to present their revitalization plans, it was evident that central to those plans were billions more dollars in taxpayer assistance.

As President Obama was correct to conclude at that point, the companies had not produced viable business plans worthy of continued financing. At that point, the president should have pointed the way toward the bankruptcy courts and moved on. Instead, he asserted a major role (and responsibility) for the administration by choosing to facilitate the bankruptcy processes of both companies by brokering pre-bankruptcy deals with major stakeholders. He even "influenced" the occasional personnel move and operational decision.

Both companies entered and emerged from bankruptcy protection in short order, restructured according to the plans crafted by the Obama administration. This testimony discusses some of the potential ramifications of the unusual bankruptcy processes and outcomes.

Ramifications of the Auto Bankruptcies

The emergence of General Motors from bankruptcy on July 10 marked the end of the first chapter of what is an evolving cautionary tale about the triumph of politics over markets and the rule of law. As the next chapter unfolds, some of the adverse consequences of a gratuitously political bankruptcy process for both GM and Chrysler are likely to become evident.

Bankruptcy was always the best option for GM and Chrysler. But both companies were resistant to filing for bankruptcy protection, allegedly because they were concerned that car buyers would eschew purchasing from companies in bankruptcy. Though it is difficult to make the case that car buyers would prefer to purchase from companies in limbo, bouncing from one bailout prospect to next, it is likely that resistance to standalone Chapter 11 filings had more to do with the kinds of changes an independent bankruptcy judge would have required to meet the threshold of a viable "going concern." But after reassuring consumers that bankruptcy did not mean liquidation and that car warranties would be honored regardless, President Obama escorted both companies into the bankruptcy process.

Indeed, the process should have begun long before then. It should have happened long before President Bush felt compelled to circumvent the wishes of Congress and "lend" Chrysler and GM $13.4 billion from the TARP allotment. It should have happened long before President Obama had the chance to promise billions more and assume a large role for the U.S. government in Chrysler's and GM's restructuring and future operations. It should have happened long before President Obama created a huge moral hazard by strong-arming Chrysler's and GM's preferred lenders into taking pennies on their loan dollars, while giving preference to claimants of lesser priority. It should have happened long before Ford, Toyota, Honda, BMW, Kia, and the rest of America's automobile industry were implicitly taxed by the government's insistence on preventing two firms from exiting the market or otherwise reducing their presence by restructuring in accordance with established bankruptcy provisions. And it should have happened long before other businesses in other industries started to get the idea that failure is the new success.

President Bush's extension of "loans" to Chrysler and GM, in circumvention of the wishes of Congress and in contravention of the express purpose of the Troubled Assets Relief Program to support "financial institutions," was the original policy sin. Without those loans, both automakers likely would have sought protection under Chapter 11 of the bankruptcy code before the end of 2008. The duration of bankruptcy may have been longer than it ultimately turned out to be, but the outcomes might have been more in line with the precedents and orthodoxy of established bankruptcy law, and consistent with expectation of how market economies are supposed to function.

Instead, on account of President Obama's doubling down by taking responsibility for crafting and ramming through the courts his prepackaged "surgical" bankruptcies, the entire auto industry faces a precarious set of circumstances. Taxpayers are now majority stakeholders in a company whose success depends on good stewardship from a 536 CEOs with disparate political interests that are not necessarily aligned with GM's business interests. Prospects that taxpayers will be made whole for their $50 billion coerced investment are dimmer than prospects that the public outlay will grow larger. As the Obama administration seeks to justify its wisdom in intervening, it will be tempted to use public policy and the tax code to tip the scales further in favor of GM, while hamstringing the competition.

Meanwhile, the United Autoworkers Union, typically more concerned about how corporate profits are carved up, rather than attained, is majority owner of Chrysler.

Neither GM's nor Chrysler's management situation is particularly confidence-inspiring, which bodes ill for the companies' prospects for raising capital to make the kinds of investments policy makers are intent on thrusting upon them in the name of emissions reduction. Prospects for raising capital in the form of debt have already suffered from the Obama administration's poor treatment of secured debt holders. Not only will that temper demand for GM's and Chrysler's debt, but for corporate debt across industries. With the economy still fragile and the number of bankruptcies still increasing, typically risk-averse preferred debt holders will be more inclined to remain on the sidelines, which will bid up the cost of debt at a time of tight credit and exploding budget deficits. It's not a pretty picture.

As one bankruptcy expert attested before this committee, the Obama administration's takeover of the bankruptcy process was a bit gratuitous.[2] The implication that our bankruptcy laws are incapable of handling reorganization of companies this large in a timely manner is at odds with historical experience.

But perhaps even more troubling in the case of GM are the fundamental conflicts inherent in simultaneously operating and regulating the same company. How will the administration and Congress balance law, compliance, policy, and the profit objective at the same time?

Conflicts between Profits and Policy

The Dealerships Issue

Support in Congress for legislation to compel the two automakers to restore contracts with dealerships slated for closure under their respective recovery plans affirms the views of skeptics: the pursuit of profits and political objectives often work at cross purposes. What is good for the bottom line is often incompatible with political objectives and political objectives are often incompatible with the bottom line. When decision makers are only concerned with one or the other, there is no problem. But when business operating decisions are also made or even just influenced by people who have politics to consider, something is going to give.

[2] Testimony of David A. Skeel, Jr., U.S. House of Representatives, Judiciary Committee hearing, May 21, 2009.

Notwithstanding the possibility that the choice of dealership closings was made arbitrarily, if not politically, the fact remains that the companies must cut costs to survive, and excessive dealership networks are an area that is ripe for cutting. According the GMs nominal CEO, Fritz Henderson, the planned distributor closings will save GM about $100 in distribution costs per vehicle. That translates into a few hundred million dollars of savings per year when factoring in the millions of units GM expects to produce.[3] That the companies face the specter of having to abandon those efforts because a majority of its 536 CEOs have political reasons for doing so bodes ill for the companies' prospects.

Not only does the dealership issue seriously elevate doubts that politics will not infect operational decisions at GM in particular, but it portends highly erratic management as the president and Congress wrestle for primacy in formulating policy at this majority taxpayer-owned entity. And since the Constitution is silent on the matter of which branch furnishes the CEO of a nationalized company, we may be in for a long period of uncertainty and instability.

The dealership issue represents just one of many potential conflicts on the horizon. We have already witnessed other clashes between what is right from a business perspective and what is imperative politically. The president's firing of Rick Wagoner and his subsequent endorsement of Fritz Henderson to fill GM's CEO slot, as well as his role in influencing the selection of GM's board members, raises questions about the administration's motivations. Is the president interested in filling key executive positions with people who are best qualified to run a profitable enterprise or who might be more amenable to the administration's plans for converting the economy from a carbon-based to a renewables-based one?

Profits vs. Green Production

The conflicts inherent between the objectives of returning GM to profitability and making it a showcase for green production should be obvious. Returning GM to profitability will require higher revenues and lower costs, neither of which is made easier by imposing more rigid CAFE standards on the automakers. To quote my Cato colleague Alan Reynolds, "General Motors can survive bankruptcy far more easily than it can

[3] http://voices.washingtonpost.com/economy-watch/2009/06/gm_chrysler_heads_face_senate.html.

survive President Barack Obama's ambitious fuel economy standards, which mandate that all new vehicles average 35.5 miles per gallon by 2016."[4]

Fuel efficiency standards are particularly punitive toward automakers that sell larger vehicles. The Big Three – GM and Ford in particular – have had their greatest success in the larger vehicle market. Their pickup trucks, sport utility vehicles, luxury cars, and muscle cars all have higher profit margins than their small vehicle offerings. But to even be eligible to sell an adequate number of these vehicles and reach overall profit targets, they must sell a sufficient number of small cars to attain a fleet efficiency of 35.5 miles per gallon. In other words, to satisfy consumer demand and realize profits on their most popular models, GM will have to sell—at low or no profit, or at a loss—a sufficient number of high mileage vehicles that are not as popular as policymakers imagine them to be.

GM in particular is at a huge disadvantage vis-à-vis the foreign nameplate producers in the United States, who already have loyal customers for their high-mileage vehicles. So Toyota and others will be able to compete with greater maneuverability in the market for large and luxury vehicles (where GM is most competitive), while GM is forced to divert resources to cultivate a skeptical market for its small cars.

Warren Brown, the *Washington Post's* auto expert, reviewed the Toyota Yaris S in his column this past Sunday. Although he is favorably disposed to the car, he writes: "[F]or all of its many virtues, the little Toyota Yaris is selling poorly in this country, where its retail numbers are down 40.4 percent in the first six months of 2009."[5] And then in a passage that speaks directly to policymakers obsessed with fuel efficiency standards, he writes: "But here is what for many of you will be a hard-to-swallow truth: Fuel-sippers such as the Yaris are selling in numbers well below those of the Ford F-series and Chevrolet Silverado picup trucks…We want cars such as the Yaris and Fit when gasoline prices are high, or when gasoline is in short supply. But when gasoline is flowing at prices that make us smile, which it usually does in the United States, we'd much rather have a Chevrolet Camarro SS with a 6.2-liter, 426-horsepower V-8 engine.

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[4] WSJ, July 2, 2009

[5] Warren Brown, "What We Say We Want, Not What We Really Want," *Washington Post*, p. G12, July 19, 2009

Strange as it might seem in these hard times, Chevrolet isn't having any trouble selling that one."[6]

The lesson here is that forcing automaker to produce vehicles that Americans demand only when fuel prices are in the $4 dollar range is not going to help GM or Chrysler. The direct and honest approach to increasing demand for small vehicles – although I do not endorse it – is a national fuel surcharge that keeps the price of gasoline relatively constant at high levels. That idea is unlikely to be very popular around the country.

Between the Congressional pushback over the dealerships issue and the insistence on higher fuel efficiency standards, we see the objectives of two broad groups of policymakers: those who want green production and treat the costs of that goal as immaterial, and those who want the auto companies to remain a jobs program, regardless of the imperative of shedding workers to become more competitive. Neither camp seems to understand or care very much that fulfillment of their objectives will only hamper recovery, at best, if not drive the automakers out of existence.

Making the Taxpayers Whole

Let us not lose site of the fact that $65 billion in taxpayer funds have been directed to GM and Chrysler over the past eight months—not as many zeroes on the end as seems to be required to get Washington's attention these days, but still a lot of money. Most Americans are not too pleased about having these "investments" made on their behalf. But Washington may be forgiven if the government divests of these companies quickly, with large enough profits and returns on investment to help soothe the public's misgivings.

In the case of GM, for taxpayers to get back their principal (without any interest or capital gain) the company will have to be worth $83 billion. That figure is derived by considering that taxpayers have "invested" roughly $50 billion in GM, which is deemed by the bankruptcy plan to be worth a 60 percent share in the company. And 60 percent of roughly $83 billion equals $50 billion. How likely is it that the value of GM will reach $83 billion anytime soon (barring dramatic inflation)?

[6] Ibid.

At its historic high value in 2000, GM's worth (based on its market capitalization) stood at $60 billion. Thus, the company’s value must increase by 38 percent from it historic high, achieved in the heady days of 2000, when Americans were purchasing 16 million vehicles per year, just to return principal to the taxpayers. But U.S. demand projections for the next few years come in at around 10 million vehicles, which suggests that prospects for the government divesting of GM profitably are extremely remote.

In fact, it is much more likely that the taxpayer investment in GM, directly or implicitly, will increase further, as the administration and some in Congress have incentive to use policy (tax policy, trade policy, and regulations) to induce consumers to purchase GM products, to subsidize production and, indeed, to hamstring GM's competition. And this all raises the question of what will happen to Ford and the other foreign nameplate producers when the lawmakers and administrators have a favorite horse in the race. Ford is relatively healthy now, but continued support for GM and Chrysler could well drive Ford to the trough, too. At some point, Ford’s management might reckon that their closest competitors, who made terrible business decisions over the years, just got their debts erased and their downsides covered. Why not travel down that path, if things get too tough? That calculation, if it is ever made, presents the specter of another taxpayer bailout to the tunes of tens of billions of dollars, and another government-run auto company.

The U.S. Auto Industry is Healthy

In 2008, the Big Three accounted for roughly 55% of U.S. light vehicle production and 50% of U.S. sales. To speak of the U.S. automobile industry these days, one must include Honda, Toyota, Nissan, Kia, Hyundai, BMW - and other foreign nameplate producers who manufacture vehicles in the U.S. They are the other half of the U.S. auto industry. They employ American workers, pay U.S. taxes, support other U.S. businesses, contribute to local charities, have genuine stakes in their local communities and face the same contracting demand for automobiles as do GM, Chrysler, and Ford. The important difference is that these companies have a better track record of making products Americans want to consume.

If GM or Chrysler or Ford went belly up and liquidated, people would lose their jobs. But the sky would not fall. In fact, that outcome would ultimately improve prospects for the firms and workers that remain in the industry. That is precisely what happened with the U.S. steel industry, which responded to waning fortunes and dozens of bankruptcies earlier in the decade by finally allowing unproductive, inefficient mills to shutter.

Bailouts or forced subsidizations are clearly unfair to taxpayers, but they are also unfair to the successful firms in the industry, who are implicitly taxed and burdened when their competition is subsidized. In a properly functioning market economy, the better firms—the ones that are more innovative, more efficient, and more popular among consumers—gain market share or increase profits, while the lesser firms contract. This process ensures that limited resources are used most productively and that the most successful firms lead us into the future.

Last November, one day before the CEOs of GM, Ford, and Chrysler told the Senate Banking Committee that their industry faced imminent collapse without an emergency infusion of $25 billion, a new automobile assembly plant opened for business in Greensburg, Indiana. Although the hearing on Capitol Hill received far more media coverage, the unveiling of Honda's latest facility in the American heartland spoke volumes about the future of the U.S. car industry.

There are plenty of healthy auto producers in the United States, all of whom are facing contracting demand. The ones that are best equipped to survive the recession will emerge stronger. But we undermine the objective if Ford, Toyota, Kia, Honda, Volkswagen and all the others cannot compete on a level playing field with GM to come up with the next generation of fuel-efficient cars.

Some Final Thoughts

The demise of these two iconic American automakers, Chrysler and GM, and the U.S. government's assumption of responsibility for their rehabilitation occasioned a direct appeal from President Obama to American economic "patriotism" a few months ago. The president exclaimed, "If you are considering buying a car, I hope it will be an American car." Ignoring, for the moment, the impropriety of the U.S. president attempting to influence commercial outcomes by endorsing particular products, even if one were inclined to buy an American car, the tricky question remains: What constitutes an "American" car? Economist Matthew Slaughter, in a recent Wall Street Journal opinion-editorial, attempted to elucidate:

> What exactly makes a car "American?" Does it mean a car made by a U.S.-headquartered company? If so, then it is important to understand that any future success of the Big Three will depend a lot on their ability to make—and sell—cars outside the United States, not in it. A big reason Chrysler has fallen bankrupt is its narrow U.S. focus. It has not boosted revenues by penetrating fast-growing markets such as China, India and Eastern Europe. Nor has it lowered costs by restructuring to access talent and production beyond North America.[7]

However, the incredulous, angry reactions from American labor unions, their patrons in Congress, and rabble-rousing television and radio personalities to GM's since-reversed announcement that its revitalization plans include shifting more production to Mexico and China suggest that the above definition of an American car is not universally embraced. For those who object to GM's plans, it is not the company's bottom line that matters, but rather the company's capacity to create U.S. jobs and stimulate U.S. economic activity. That GM might need to start making profits in order to create U.S. jobs and stimulate U.S. economic activity somehow doesn't factor into the equation for these detractors. Instead, in zero-sum fashion, they see investment in foreign operations as antithetical to domestic job creation and economic growth.[8]

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[7] Matt Slaughter, *Wall Street Journal*, May 7, 2009

[8] For the record, the empirical evidence supports a positive relationship between the growth of a company's foreign operations and the growth of its domestic operations. Following is an excerpt from Daniel T. Griswold, "'Shipping Jobs Overseas' or Reaching New Customers? Why Congress Should not Tax Reinvested Earnings Abroad," Cato Institute Free Trade Bulletin No. 36, January 13, 2009: "Investing abroad is not about 'shipping jobs overseas.' There is no evidence that expanding employment at U.S.-owned affiliates comes at the expense of overall employment by parent companies back home in the United States. In fact, the evidence and experience of U.S. multinational companies points in the opposite direction: foreign and domestic operations tend to compliment each other and expand together. A successful company operating in a favorable business climate will tend to expand employment at both its domestic and overseas operations. More activity and sales abroad often require the hiring of more managers, accountants, lawyers, engineers, and production workers at the parent company."

Perhaps, then, they would find Slaughter's alternative definition of an American car more accurate:

> Or is an "American" car one made within U.S. borders? If so, then it is important to understand that America today has a robust automobile industry thanks to insourcing. In 2006, foreign-headquartered multinationals engaged in making and wholesaling motor vehicles and parts employed 402,800 Americans—at an average annual compensation of $63,538—20% above the national average. Amid the Big Three struggles of the past generation, insourcing companies like Toyota, Honda and Mercedes have greatly expanded automobile operations in the U.S. In fiscal year 2008, Toyota assembled 1.66 million motor vehicles in North America with production in seven U.S. states supported by research and development in three more.[9]

But many Americans have rejected this definition of an American car as well. Ironically, the people who are most inclined to oppose outsourcing and define it as "shipping jobs overseas" tend to be the same people who criticize insourcing for shipping control of U.S. assets overseas. Even though the top 10 selling models of cars and trucks in the United States in 2008 were all produced in the United States, by American and foreign nameplate producers, and even though foreign nameplate producers employ hundreds of thousands of American workers, pay local and national taxes, support local economies, reinvest part of their earnings in their U.S. operations, and invest in other local businesses, the fact that corporate headquarters are located in Tokyo or Stuttgart or Seoul seems to hold sway.

At best, there is grudging acceptance of the possibility that these "insourcing" companies are part of the American manufacturing landscape, but it is impossible to imagine that the U.S. government would have ever rescued Toyota or Honda, if they had presented with financial prospects as dire as Chrysler's and GM's. Yet, as put in another recent Wall Street Journal article:

> Once you put down the flags and shut off all the television ads with their Heartland, apple-pie America imagery, the truth of the car business is that it transcends national boundaries. A car or truck sold by a "Detroit" auto maker such as GM, Ford or Chrysler could be less American—as defined by the government's standards for "domestic content"— than a car sold by

[9] Slaughter.

> Toyota, Honda or Nissan—all of which have substantial assembly and components operations in the U.S.[10]

The automobile industry is one of many that "transcends national boundaries" and is only one example of why international competition can no longer be described as a contest between "our" producers and "their" producers. But the same holds for industries throughout the manufacturing sector. The fact is that the distinction between what is and what isn't American has been blurred by foreign direct investment, cross-ownership, equity tie-ins, and transnational supply chains.

It's time for U.S. economic policy to catch up to that commercial reality.

[10] Joseph B. White, "What is an American Car?" *Wall Street Journal*, January 26, 2009.