How Detroit Went Bottom-Up

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Outsourcing has made the automotive industry so co-dependent and fragile that one company's downfall is every company's concern.

In the spring of 2005, David Stockman at last reaped the reward of the monopolist.

Stockman, who once served as Ronald Reagan's budget director, spent two decades on Wall Street preparing for this moment. After stints at Salomon Brothers and the Blackstone Group, Stockman in 1999 set up his own private investment fund, Heartland Industrial Partners. He then used Heartland to shape a set of companies -- mainly in the automotive sector -- each dedicated to dominating a particular group of production activities.

Of all Stockman's efforts, his most audacious centered on a firm named Collins & Aikman. Stockman used C&A as a vehicle to buy up small producers of interior components like dashboards and seats, and he swiftly captured a position supplying parts to more than 90 percent of all cars built in America. Although the acquisition spree left C&A saddled with debt, Stockman was so pleased with C&A's prospects that in 2003 he assumed control as chief executive officer.

When the time came to choose his first target, Stockman took aim at Chrysler. The company offered ready cash; Chrysler was still controlled by the deep-pocketed German automaker Daimler. And it had a fat vulnerability; in early 2005 the company had a big hit with its Chrysler 300 sedan. Stockman's message was simple: Pay a premium for C&A? manufactured components, or he would shut off the flow of critical supplies to the main assembly line of this highly lucrative car.

Not many years ago, it was all but unthinkable that a mere supplier would dare to hold up one of the Big Three in such a blatant manner. As *The Detroit Free Press* reported at the time, such acts were considered "the auto industry equivalent of a nuclear weapon -- rarely threatened and almost never used." But Stockman's gambit worked perfectly. Chrysler agreed to provide C&A with between $65 million and $75 million in the second and third quarters of 2005. Better yet, General Motors, Toyota, and other big automakers with North American plants heard Stockman's message loud and clear. Even without direct threats, they agreed to provide Stockman and C&A with another $260 million to $270 million in price increases and low-cost loans.

Unfortunately for Stockman, he appears to have mis-timed his play for a big payday. More specifically, this onetime head of the Office of Management and Budget (who in 1981 angered his fellow Reagan revolutionaries when he told reporter William Greider that "none of us really understands what's going on with all these numbers") failed to keep his own creditors at bay. On May 12, 2005, Stockman was fired by the C&A board. Five days later, C&A filed for bankruptcy.

In and of itself, Stockman's stickup of America's automotive industry is not an especially important event. The problem is that Stockman was not alone. In recent years, many other monopolists made similar plays in the supply system that serves the American automotive industry. The result was a process of bottom-up consolidation that revolutionized the financial and physical structures of the entire industry in ways that undermined its stability and sustainability.

This type of consolidation is not limited to the automotive sector. On the contrary, Stockman's monopoly and subsequent power play exemplify what we have witnessed -- often on a far grander scale- -- in most of the vital industries on which we rely.

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The idea that America's automotive industry has been monopolized in any respect can seem absurd. After all, when we shop for a new car, many different companies vie for our dollars, with sometimes manic vigor. But under the hood, whether it's a Ford or a Chrysler or a Toyota, a growing proportion of the component parts were made by the same set of manufacturers, often on the same production lines.

This is remarkably different from the way the automobile industry used to be organized. Well into the 1990s, most manufacturers were vertically integrated and built most of the components for their products in their own factories. The great apostle of vertical integration was Henry Ford, who erected an industrial complex outside Detroit where ships unloaded coal and iron ore at one end and workers drove finished Model As onto railroad cars at the other. Over the course of the 20th century, almost all of America's biggest industrial corporations, including IBM, DuPont, and General Electric, adopted this same basic structure. One result of such vertical integration was that almost all key industrial activities were replicated many times over. In the auto industry, for instance, every firm manufactured its own alternators, piston rings, and windshield wipers.

Vertical integration was neither a necessary nor natural form of organization. The history of industrial activity is replete with systems in which many producers competed with one another in open market-centered arrangements. Early in the 20th century, Detroit was home to a great many small and medium-sized manufacturers engaged in vibrant competition. The vertical integration model is merely a business strategy, one that managers pursue to gain an advantage over their competitors or to protect themselves from predation. That said, in 20th-century America, the model became the norm.

In the late 1980s and early 1990s, managers in many industries began to embrace an alternative strategy: outsourcing. There was nothing especially new about outsourcing; the term implies little more than the disintegration of a vertically integrated firm. Nor was there anything mysterious about why managers began to split apart what their forebears had joined together. Laws and customs had begun to change.

One of the most important changes was private and voluntary. Impressed by the quality of Toyota's cars and the efficiency of its plants, American managers began to study that company's production methods, which aimed to eliminate all parts inventories through a more flexible use of machinery and workers. This led many manufacturers to embrace such related Toyota strategies as reliance on single sources of supply, often located outside the company.

Meanwhile, laws designed to bring American corporations more directly under the control of financiers encouraged corporate managers to focus more on making money and less on making quality goods. Liberalization of trade laws reduced fears -- both among managers and the population in general -- of mercantilist aggressions by nations like Japan, China, and Germany. Most important was the Reagan administration's overthrow of antitrust law in 1981, an act that established a new overarching goal for regulating competition. Rather than seek to ensure competition for the sake of competition, the aim now was to clear the way for any efficiencies that might benefit the consumer, no matter how much consolidation this entailed.

The result was an entirely new legal environment, one that made breaking up the traditional industrial complex much more attractive. Outsourcing offered a quick path to cash, as it enabled managers simultaneously to sell off in-house operations and to offload costly liabilities like union pensions. Outsourcing also promised longer-term savings as managers began to take advantage of the more lax competition laws to pool some production activities with rival companies. In the automotive industry this pooling took place in two ways. First, managers gathered in-house operations into new units and then spun these units off as independent firms that were free to serve competitors; two of the biggest products of this reorganization were Delphi, spun off by General Motors, and Visteon, spun off by Ford. Second, managers at different automakers increasingly turned to the same existing suppliers, like Bosch and C&A, for the same parts.

Top auto-industry managers never expected that the pooling of supply activities would continue to a point where any outside supplier would manage to capture nearly complete control over a production activity. On the other hand, no manager at a top-tier firm appears ever to have made any concerted effort to prevent such consolidations. The general assumption seemed to be that this industrial system would somehow regulate itself and that new suppliers would continue to emerge naturally.

And so the path was left open for private financiers like David Stockman, and for managers at parastatal corporations in nations like Japan and China, to grab whatever production activities they wished and to consolidate them to whatever degree they desired. The result was a process of monopolization entirely unlike what we have seen in the past. Traditionally, monopolies have been imposed from the top down, via the merger of top firms or the bankruptcy of main rivals. Over the last three decades, by contrast, monopolization in complex industries has usually taken place mainly in the supply base, proceeding from the bottom up.

The resulting structure is unlike any we have seen before. One way to understand this new organization of industrial activity is to conjure a picture of the mythological Greek monster the Hydra. In the case of the auto industry, we see many heads, with names like General Motors, Toyota North America, and Ford. We also increasingly see a single body, composed of an ever shrinking number of ever more specialized firms, like C&A, that dominate supply of some component or family of products, be it piston rings or electronic controls or cockpit assemblies.

Monopolization always creates certain basic problems, especially a tendency toward higher prices and slower innovation. But the bottom-up monopolization of an entire supply base also poses entirely unprecedented financial and physical dangers, precisely because it proceeds without any direction by any rational governor (private or public).

There is no one with any interest in ensuring the safety and stability of the system as a whole.

The Obama administration's economic team deserves much credit for its handling of the American auto industry. When President Barack Obama took office in January, General Motors and Chrysler were basically bankrupt while Ford's fate was cloudy at best. In remarkably swift fashion, the Auto Task Force managed to cleanse both GM and Chrysler of bad debt and excess dealers. And it did so in a way that did not punish companies like Ford and Toyota for having done a better job of managing their assets.

But the bailout of Detroit is just the first step in a much wider-ranging process. With the immediate crisis averted, we need to address the growing instability of this industrial system. To do so effectively, we must first understand the fundamental structural flaws created by bottom-up monopolization. Three are paramount.

The first fundamental flaw is that competition within such a structurally monopolized system can result in the destruction of the real properties and the capital society has entrusted to both the lead corporations and their suppliers. Some destruction results from any act of monopolization, of course, as alternative workers, technologies, and equipment are eliminated. The deeper problem is that such destruction often continues even after monopolization in the supply base is more or less complete.

One of the most stubborn myths about monopolization is that it eliminates competition, making it easier for both managers and financiers to plan and invest for the long term. In practice, monopolization only redirects competition. In place of competition along horizontal lines (between firms vying to offer the same basic products and services) monopolization tends to increase competition along vertical lines. Such competition can take place within a firm, such as between the workers who actually create a product and the financiers who control the corporation. Or it can take place among the various firms in a production chain. In the most common instance, a firm that has captured control over a particular market may use that power to strip profits from suppliers that depend on the lead firm to get to their customers. But as we've seen with C&A and other giant component-makers such as Intel, dominant suppliers can also strip profits from lead firms.

A system that fosters rivalry among large lead firms and consolidation among smaller suppliers can be especially destructive because it combines vertical and horizontal competition in a way that can all but guarantee the bankruptcy of all the major players in the system. At one end of the system, immensely powerful lead firms like Toyota and Ford are still engaging in the sort of tough, horizontal competition that tends to limit the total amount of cash flowing into the production system as a whole. At the other, chaotic vertical competition between these powerful lead firms and dominant suppliers like C&A can prevent both the lead firms and the suppliers from stabilizing their cash flow.

Such a system, in other words, is composed of bankrupt lead firms with the power to bankrupt their suppliers, and bankrupt suppliers with sufficient power to bankrupt lead firms.

The second fundamental flaw with such structural monopolization is that it can be very difficult, if not impossible, to isolate and to punish economic failure. Any sudden failure of either a large lead firm or a dominant supplier has the potential to create massive financial disruptions. This means that when the managers of a large lead firm, like GM, act irresponsibly, the other members of the system -- or the government -- have no choice but to bail the firm out to prevent the whole system from seizing up. In such a tightly communalized system, even many small players are too big to fail.

Ford CEO Alan Mulally offered one of the clearest descriptions of this dilemma in testimony to Congress last fall. The automotive industry is "uniquely interdependent," he said. This was particularly true "with respect to our supply base, with more than 90 percent commonality among our suppliers. Should one of the other domestic companies declare bankruptcy, the effect on Ford's production operations would be felt within days -- if not hours." Which is why, contrary to all traditional economic theory, Mulally went on to plead for a bailout of Ford's arch rival, GM. And why Toyota executives soon followed suit.

The third fundamental flaw with such bottom-up structural monopolization is perhaps the most disturbing -- not least because the potential disaster here is one that no mere financial bailout can fix. In any system organized along these lines, a natural or man-made disaster that knocks some keystone factory off line can trigger a cascading industrial crash that paralyzes production everywhere. The best recent illustration of how such a crash plays out comes from Japan, where the automotive industry there has been structurally monopolized in much the same way as in America. The fantastic physical instability of such a structure was made clear in July 2007, when an earthquake in Niigata province smashed a piston-ring factory run by a small supplier named Riken. Within hours, the loss of this one plant led all 12 of Japan's main car and truck manufacturers to shut down. It turned out they all relied on one factory to produce a component that cost less than $5.

The old vertical integration model isolated financial and industrial risk and all but forced managers to act responsibly. Bottom-up structural monopolization, by contrast, results in a system that almost instantly transforms one company's disaster into every company's disaster.

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When Reagan officials overturned our traditional approach to enforcing anti-monopoly law, they did so for purely political reasons. Their immediate goal was to privatize the power to regulate competition and then use that power to erect institutional structures that would enable the few to consolidate wealth and power in society as a whole. A generation later it is clear that this radical political act also resulted in a revolutionary restructuring of many of our most vital production systems in ways that left them far more vulnerable to financial and physical disruptions.

That's why it is vital to understand that the sort of consolidation we have witnessed in the automotive industry is true of most of the industrial systems that serve us today. We first saw such a process of bottom-up structural monopolization take hold in the electronics industry in the late 1980s, as a variety of private firms and national governments exercised power in ways that enabled them to capture control over one production capability or technology. Since then we have seen the process play out in the chemical and metal industries, and in service industries such as information processing and finance. Perhaps most terrifying, this specialization and concentration is increasingly imposed on our industrial food and pharmaceutical sectors.

In a sense, David Stockman and the other monopolists in the automotive industry have done us a favor. The fact that they were able to consolidate so many activities so swiftly in such a big and complex industry proves that we must act now to reverse the process everywhere. It also illuminates the fantastic folly of placing in private hands the power to regulate competition within vital industrial systems, in ways that aim not at the common good but at private profit only.

The good news is that Americans are very adept at making systems stable and safe. We long ago learned how to build compartments into our ships and circuit breakers in our electrical systems and alternative routers in the Internet. We also learned how to build financial reserves into our banks and how to regulate our industrial systems to be the most resilient and productive on Earth.

In the case of our automotive industry -- and most of the complex industrial activities where we have seen bottom-up monopolization -- we can choose between two ways of making these systems once again financially and physically stable.

One is to treat these industries as the semi-monopolized utilities they now are and create a single sovereign body to regulate them from the top down, in a way that ensures their physical and financial stability. Such a regulator can be public (the government) or it can be private (a cartel of leading firms tasked with ensuring that all players share all costs fairly).

The alternative is to reform the various legal regimes (including trade and corporate governance as well as antitrust) that determine how corporate managers structure the industrial systems on which we depend, in order to ensure real "competition" both among giant lead firms like Ford and Toyota and among the companies that manufacture components for them. The immediate goal would be to guarantee that no group, either a private business corporation or a nation state, can ever seize control of any industrial activity on which we depend, no matter how small. The natural byproduct of such a system would be redundancy and resiliency.

The one option that is not acceptable is to do nothing. These systems are too vital to leave in such a fragile state. We have a choice: We can complete the construction of the top-down, semi-authoritarian, corporatist industrial system that all but inevitably resulted from the evisceration of our antitrust and trade laws. Or we can revert to our traditional American approach of enforcing competition, at home and abroad, in ways that harness such energies always to constructive ends.
