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What caused the crash?

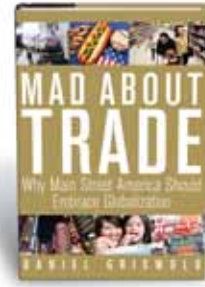
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Hard Lessons from the Auto Bailouts

BY DANIEL J. IKENSON

November 5 marked the one-year anniversary of the public unveiling of a report 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. Detroit's media blitz was underway. It was timed to remind the president-elect, as he contemplated his victory the morning after, of the contribution to his success by certain constituencies now needing assistance themselves.

The CAR report's projection of three million lost jobs was predicated on the 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, then 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 mainstream media obliged the script, elevated the automobile industry "crisis" to the top of the news cycle for the next month,

and helped mold 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, even as evidence of the misguided financial bailout was surfacing and despite compelling evidence that the automakers were unworthy.

Public opinion was initially sympathetic to the Main Street characterization but changed instantly when the chief executives of General Motors, Ford, and Chrysler laid waste to months of effort and resources spent trying to cultivate a winning message by arriving in Washington, tin cups in hand, aboard separate corporate jets. That fateful incident turned the media against Detroit and

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Two leaders in the fight to bring free markets to the former Soviet countries shake hands at a Cato Institute conference, "Freedom and Prosperity in Central and Eastern Europe: 20 Years after the Collapse of Communism," in September. Kakha Bendukidze (second from left), former economic reform minister of Georgia, and Vaclav Klaus, president of the Czech Republic, spoke about successful reforms in their respective countries, as well as the continuing struggle to bring capitalism to the formerly communist countries. Cato senior fellows Tom G. Palmer (left) and Richard Rahn look on.

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reminded Americans that the automakers were in dire straits because of bad decisions. It helped convince the public that a shake out, not a bailout, was the proper course of action.

Although legislation to provide funding to the automakers passed in the House in December 2008, the bill did not garner enough support in the Senate, where it died. Prospects for any form of taxpayer bailout seemed remote, and Chapter 11 appeared imminent for both GM and Chrysler. The country, it seemed, had dodged an interventionist bullet.

Then just days after Secretary Paulson pointed out that he had no authority to use funds from the Troubled Assets Relief Program for an auto bailout, President Bush announced that he would authorize bridge loans from the TARP of \$9.4 billion to GM and \$4.0 billion to Chrysler.

With the companies incurring \$6 billion of operating losses per month, it was easy to see that those funds would be exhausted in a matter of months. And when Chrysler and GM returned to Washington—as stipulated in the terms of the loans—to present their revitalization plans to the new president, it was evident that central to those plans were billions more dollars in taxpayer assistance.

President Obama was probably correct to conclude that the companies had not produced viable business plans—although, really, why should that be the president's decision? At that moment he should have pointed the way toward the bankruptcy courts and walked away. Instead, he asserted a major role (and responsibility) for the administration by choosing to broker pre-bankruptcy deals for both companies with the major stakeholders.

To be sure, President Bush's extension of \$13.4 billion in "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, neither automaker would have had an alternative to filing for bankruptcy protection before the end of 2008.

Bush's loans bought time for the companies and the United Auto Workers to convince President-elect and then President Obama

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of their fears about traditional bankruptcy. The public was told that consumers wouldn't buy cars from companies in bankruptcy. But fear of the concessions an independent bankruptcy judge likely would have required from the UAW, as well as the allure to the Obama administration of interceding and crafting a more pliable entity to showcase green production were the real reasons for avoiding orthodox Chapter 11 procedures. On June 1, one month after Chrysler filed its pre-packaged bankruptcy plans, President Obama announced GM's similar plans:

I'm confident that the steps I'm announcing today will mark the end of an old GM, and the beginning of a new GM; a new GM that can produce the high-quality, safe, and fuel-efficient cars of tomorrow; that can lead America towards an energy independent future; and that is once more a symbol of America's success.

In a matter of weeks, both GM and Chrysler emerged from Chapter 11, restructured mostly in accordance with the plans crafted by the Obama administration with taxpayers owning 60 percent of GM and 10 percent of Chrysler.

In mid-September, President Obama told a gathering of GM workers in Ohio, "Your survival and the success of our economy depended on making sure that we got the U.S. auto industry back on its feet." In other words, the president got the auto industry "back on its feet."

In the administration's telling of the auto industry saga, a knight in shining armor appears, rescues the national treasures, and

everyone lives happily ever after. But that version is merely a romanticized ending to the first chapter, which could be titled "Pandora Opens the Box." The real question now is how much damage will be caused by the monsters Pandora let out.

GOVERNMENT MOTORS

Normal bankruptcy proceedings should have started long before Bush's loans; long before President Obama had the chance to promise billions more and assume a large role for the federal government in Chrysler's and GM's restructuring and future operations. They should have started long before President Obama ran roughshod over established bankruptcy procedures and strong-armed Chrysler's and GM's preferred lenders into taking pennies on their loan dollars, while giving preference to claimants of lesser priority; long before Ford, Toyota, Honda, BMW, and the rest of America's automobile industry were denied the spoils of competition and implicitly taxed by the government's intervention; and long before other businesses in other industries started to get the idea that failure would be rewarded.

But it didn't happen that way. Instead, taxpayers are now majority stakeholders in a company whose success depends on good stewardship from 537 CEOs, most of whom do not consider GM's bottom line a priority. The pursuit of profits and political objectives often work at cross purposes, and many in Congress see GM as a vehicle through which to demonstrate the virtues of green production, regardless of economic viability. Others see GM as a jobs program, also without regard to the economics.

One of GM's first decisions upon emerging from bankruptcy was to announce closures of a number of dealerships to help reduce costs. Congress reacted by pressuring GM to reverse many of those decisions, and the House of Representatives passed a bill requiring companies that received federal funds to reestablish terminated dealership agreements.

Notwithstanding the possibility that the choice of dealership closings was made arbitrarily, if not politically, by the president's Auto Task Force, the fact remains that GM's extensive dealership networks are ripe for

cost cutting. According to GM's nominal CEO, Fritz Henderson, the planned dealer closings would 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.

The lesson that GM cannot implement a crucial operational decision without running things by its many overlords bodes poorly for the company's prospects. It portends highly erratic management as the president and Congress wrestle for decisionmaking primacy at this majority taxpayer-owned entity. We may be in for a long period of uncertainty and instability, since the Constitution is silent on the matter of which branch of government furnishes the CEO of a nationalized company.

There have already been other clashes between what might be right from a business perspective and what might be imperative politically. The president's firing of Rick Wagoner, his subsequent endorsement of Fritz Henderson to fill GM's CEO slot, and his role in influencing the selection of GM's board members raise 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 with those who might be more amenable to the administration's plans for converting the economy from carbon-based fuels to renewables?

Returning GM to profitability will require higher revenues and lower costs, neither of which is made easier by imposing rigid CAFE standards. GM has had its greatest success in the larger vehicle market. GM's pickup trucks, sport utility vehicles, luxury cars, and muscle cars all have higher profit margins than its small vehicle offerings. But to even be eligible to sell an adequate number of those popular vehicles and reach overall profit targets, GM must sell a sufficient number of small cars to attain an average fleet efficiency of 35.5 miles per gallon by 2016. 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.

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GM 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. Toyota and others should have no problem meeting average mileage standards and competing 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. To quote my colleague Alan Reynolds, “General Motors can survive bankruptcy far more easily than it can survive President Barack Obama's ambitious fuel economy standards.”

Forcing the automaker to produce vehicles that Americans don't want is not going to help GM. But before policymakers get it in their heads that the way to increase demand for small cars is to impose a national gasoline tax, they should know that, in addition to being hugely unpopular, such a measure would expedite GM's demise. Small car purchasers prefer other brands.

We know this from the dynamic that played out this past summer under the “Cash for Clunkers” program. Auto buyers were given financial incentives to choose more fuel-efficient models and the results could not have been clearer. The top ten sellers included three Toyotas, three Hondas, two Fords, one Hyundai, and one Nissan. The best selling GM offering under the program was the Chevy Cobalt, which was not even a top ten seller, exacerbating the company's market share contraction, and rendering Cash for Clunkers the latest government brainchild to work at cross purposes with the grand objective of returning GM to health.

THE U.S. AUTO INDUSTRY IS HEALTHY

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. And it underscored the absurdity of the president's triumphalist claim that he “got the auto industry back on its feet.”

In 2008, the Big Three accounted for roughly 55 percent of U.S. light vehicle production and 50 percent of U.S. sales. Honda, Toyota, Nissan, Kia, Hyundai, BMW, and other foreign nameplate producers who manufacture vehicles in the United States are the other half of the domestic industry. They employ Americans, pay U.S. taxes, buy from U.S. businesses, contribute to charities, and have genuine stakes in their local communities.

Industry bailouts are certainly unfair to taxpayers—as well as to the firms not seeking handouts, who are implicitly taxed when their weaker competition is subsidized. In a properly functioning market economy, the better firms—those that are more innovative, more efficient, and more successful—gain market share or increase profits, while the lesser firms contract. This evolutionary process ensures that limited resources are used most productively and that the most eligible firms lead their industries into the future.

There are plenty of healthy auto producers in the United States. The ones that are best equipped to survive the recession will emerge stronger. But that process is undermined when 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, luxury vehicles, and gas-guzzling SUVs. The prospect that the government will throw more of its heft in support of GM is cause for genuine concern.

MAKING THE TAXPAYERS WHOLE

As a conservative estimate, the government has directed \$65 billion of taxpayer money

to GM and Chrysler since December 2008—a bargain by Wall Street bailout standards, but still a lot of money. Most Americans are none too pleased about having these “investments” made on their behalf, so the president has some incentive to make the taxpayers whole. But the likelihood that taxpayers will be made whole is dwarfed by the likelihood that the public outlay will grow larger.

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 from the fact that taxpayers have “invested” roughly \$50 billion in GM, which is deemed by the bankruptcy plan to be worth 60 percent of the company. How likely is it that the value of GM will reach \$83 billion anytime soon?

At its historic high value in 2000, GM’s worth (based on market capitalization) stood at \$60 billion. Thus, the company’s value must increase by 38 percent from its 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. 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. A September report from an independent Congressional Oversight Panel reviewing the matter concludes that taxpayers are unlikely to be made whole.

Ultimately, the administration and Congress might succumb to the temptation to use public policy and the tax code to push consumers, subsidize particular products, or otherwise tip the scales further in favor of GM—again. What will happen to Ford and the foreign nameplate producers when policymakers have a favorite horse in the race? Ford is relatively healthy now, but continued assistance to GM could well drive it to the trough, too. The day may come when Ford’s management decides to travel down that path, figuring that its closest competitors, who made bad decisions over the years, got their debts erased and their downsides covered. 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.

BAD PRECEDENTS AND POSSIBLE ILLEGALITIES

The crisis atmosphere that prevailed for the better part of a year invited rationalizations from officials in all three branches of the federal government for skirting the rules, making exceptions, passing the buck, and assuming nonexistent powers. From the misuse of TARP funds by two presidents to the marginalization of “takings” claims of secured creditors resulting from President Obama’s heavy-handed bankruptcy tactics to the courts’ lip service to justice in its repeated deference to executive claims that time was of the essence, longstanding American institutions have been weakened to our collective detriment.

When bad firms are rewarded and good firms penalized, the incentives soon fail to support progress. When investors can no longer be certain that property rights underpin their claims, they will take their money elsewhere. When political expedience surpasses law and justice as a guiding virtue, productive resources will be diverted to serving political, rather than economic ends. These should be the hard lessons of the auto bailouts.

It's the season of giving.

It's that time of year again—when we think about giving, and about our end-of-the-year tax and financial situation. We hope you'll take a moment to think about the Cato Institute's mission to advance liberty and limited government in the United States and around the world.

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