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THE CHRYSLER BAIL-OUT BUST

INTRODUCTION

Chrysler Corporation auto sales are roaring into high gear. And so is the myth of the Great Chrysler Comeback. The resurgence of the once dying automaker has become the favorite example cited by proponents of national industrial policy who call for massive and costly federal efforts to revive what they describe as a desperately ailing American economy. The way they tell the story, Chrysler in 1979 seemed destined for bankruptcy, and now it's showing a profit. What saved Chrysler, we are told, are the \$1.2 billion in loan guarantees provided by the federal government--so successful was the timely injection of cash that the company could announce today that it will pay off the remaining \$800 million by September. And it didn't cost the taxpayer a penny, did it, they ask gloatingly. Chrysler chairman Lee Iacocca, who came to Washington four years ago with begging bowl in hand, is now in the vanguard of the push for more government intervention in American industry. Federal loan guarantees, import quotas, and a well-defined industrial policy, he promises, will be the key to American corporate success in the years ahead.

If it all seems too good to be true, it is because it isn't true. The popular version of the Chrysler bail-out is simply a fairy tale. The bail-out is a bust. Closer scrutiny of it reveals that the "great success" rests on a bedrock of myths and half-truths. These myths cloud and distort important issues involved in the larger question of industrial policy and a closer business-government relationship. Confronting the Chrysler myths with Chrysler facts reveals Chrysler's true financial condition and the real impact of those federal guarantees. It shows that if the bailout is indeed the model for an American industrial policy, the consequences could be disastrous.

Myth No. 1: Government loan guarantees prevented the Chrysler Corporation from going bankrupt.

The truth is that the Chrysler Corporation has gone bankrupt by every normal definition of the word. In the past three years, Chrysler has renegotiated its debts and restructured its organization in a way that greatly resembles a company going through Chapter 11 bankruptcy. Its creditors, like those of bankrupt firms, were forced to swallow sizeable losses.

This was the result of a clause in the Chrysler Corporation Loan Guarantee Act of 1979 that required creditors to make certain "concessions" to Chrysler. With this clause to exploit and with Treasury Department officials, including then-Secretary William Miller, pressuring its creditors, Chrysler was able to pay off more than \$600 million in debts at just 30 cents on the dollar. In addition, the company was allowed to convert nearly \$700 million in debts into a special class of preferred stock--paper relatively worthless in the financial markets because the shares earned no dividends and were to be unredeemable for several years. In early 1983, Chrysler reached a tentative agreement with its creditors to trade this preferred stock for Chrysler's regularly traded common stock. However, the creditors still get the short end of the financial stick: the face value of the common stock to be received will almost certainly be less than the face value of the original debt.

Chrysler's creditors are not alone in being socked by the company's quasi-bankruptcy. The firm's workers have paid an even greater price. Despite the fact that the loan guarantees were approved by Congress mainly to protect jobs at Chrysler, the company has sent home nearly half of its employees, cutting its white-collar work force by 20,000 and laying off 42,600 of its hourly workers since the loan guarantees were signed into law. Many observers, including Senator William Proxmire (D-Wis.), complain that the number of employees laid off at Chrysler in this period is at least as large--and may even have been larger--than the number of jobs that probably would have been lost had Chrysler actually been forced into bankruptcy.

The only difference between the actual bankruptcy that Chrysler faced in 1979 and the quasi-bankruptcy that Chrysler has gone through in the past three years is that under this quasi-bankruptcy the federal government is responsible for guaranteeing over \$1 billion in Chrysler loans. Chrysler's creditors and employees have paid a price no different than they would have paid in reorganization under the bankruptcy laws. If it has not been the workers and creditors who have benefitted from federal generosity, who has? The answer: Mainly Chrysler's shareholders.

But not even all of Chrysler's shareholders benefitted: sensible stockholders--the ones who carefully monitored Chrysler's financial and management performance--probably sold the stock well before the bailout occurred. Therefore, only two types of Chrysler stockholders really benefitted from the bail-out: (1) less informed

investors who either ignored the warning signs of Chrysler's impending bankruptcy or else failed to act on them, and (2) the stockholders who were gambling that the federal government would come to Chrysler's rescue and minimize their potential losses.

The Chrysler version of industrial policy, therefore, fleeced the company's creditors, resulted in a 50 percent reduction in Chrysler's workforce, rewarded the least deserving of Chrysler's stockholders, and let the U.S. taxpayer risk his money in a bankrupt company. This we are told, is the shining example for America's new industrial policy.

Myth No. 2: Federal loan guarantees were justified because Chrysler's financial problems were brought on by the federal government.

Although federal regulations have certainly played a part in the financial decline of the automobile industry, these rules apply to every firm in the industry, not just Chrysler. It was Chrysler's management, rather, which put it on the road to bankruptcy. Throughout the late 1930s and into the early 1940s, Chrysler was actually the second largest car manufacturer in the United States, ahead of Ford. The company's problems began shortly after World War II, when it decided to stick with prewar manufacturing and styling methods instead of retooling to meet the expectations of postwar automobile buyers. Ford and General Motors, in contrast, developed a sleek and streamlined design that sold well.

By the time Chrysler's management admitted their mistake in the 1950s, the company had slipped to third place among the nation's automakers. But because Chrysler's new management reacted by emphasizing sales and production over engineering, the firm's cars were little more than delayed copies of Ford and General Motors products. "Chrysler was always into a fad, but always into it at the tail end, after it had crested," says Maryann Keller, automobile industry analyst for Paine Webber.

Even Chrysler chairman Lee Iacocca does not accuse the federal government of total responsibility for Chrysler's plight. "I don't blame regulations for all of Chrysler's problems," Iacocca admitted to a congressional committee. "I think that half of all Chrysler's problems were tough management mistakes." Regulations may have played a part in forcing Chrysler over the edge, but the stage had been set for Chrysler's problems long before seat belts and bumper standards were a gleam in the regulators' eyes.

Myth No. 3: The loan guarantees cost nothing since Chrysler has not gone bankrupt.

Under the provisions of the Loan Guarantee Act, Chrysler is supposed to compensate the federal government for the risk that the government has taken in making the guarantees. The House Committee on Banking, Finance, and Urban Affairs defined this risk as "the difference between the rate that the guaranteed loans

carry and the rate that Chrysler would be required to pay if the loans were obtained without the federal guarantees."¹

Just how large is the difference between the two rates? In early 1980, Chrysler was able to issue government-guaranteed bonds at an interest rate of only 10.35 percent, while Ford Motor Company was forced to pay about 14.50 percent for its unguaranteed bonds. If Chrysler did not have the loan guarantees, it would almost certainly have to pay a higher interest rate on its bonds than the more secure Ford Motor Company. Therefore, one would assume that Chrysler should be paying the federal government a guarantee fee of at least four percent. Yet Chrysler pays only one percent, or about \$12 million a year.

Chrysler attempted to make up the difference by giving the government 14.4 million "warrants," which are certificates that give the government the right to purchase a share of Chrysler stock at \$13 a share. Even if the stock price does rise to the point where American taxpayers would be fully compensated for the \$300 million in interest subsidies that Chrysler will enjoy during the 1980s, the company is clearly not eager to see taxpayers collecting on those warrants. In early 1983, Chrysler publicly demanded that the Treasury Department return the warrants to Chrysler, claiming that cashing in now-valuable warrants would amount to "usury." Due to adverse public reaction, a Chrysler spokesman said that the company "would not press" the demand at this time.

Moreover, Chrysler has petitioned the federal government to reduce the one percent loan guarantee fee it currently pays down to the statutorily mandated minimum of one-half percent. The federal government put more than one billion in tax dollars at risk for Chrysler. But if Chrysler survives it appears that the company is very reluctant to reward Uncle Sam for that risk.

Myth No. 4: Chrysler's top management has taken deep salary cuts until Chrysler's financial problems are resolved.

When Chrysler was petitioning the federal government for the financial assistance it wanted, in 1979, the company announced its Salary Reduction Program. Under this, executive salaries were cut between two and ten percent; Lee Iacocca's salary was reduced to one dollar a year (although it was made clear that, under the program, Iacocca would collect the balance of a recruitment bonus due to him in 1980). If Chrysler's financial performance was adequate after two years, the executives would be eligible to receive retroactive salary payments to make up for these reductions.

Despite the fact that Chrysler lost nearly \$500 million in 1981, the Salary Reduction Program ended that year, and executive salaries were restored to their 1979 level. Moreover, the company

¹ House Report No. 96-690, December 6, 1979.

made retroactive payments to its executives for about two-thirds of the income they lost while the program was in effect, on the theory that its stock price in 1981 was about two-thirds of its 1979 price. Iacocca himself received over \$360,000 in salary, supplemental payments, and director's fees in 1981--including "amounts paid in accordance with the Salary Reduction Program," according to documents filed with the Securities and Exchange Commission. All of this despite the fact that Chrysler was still losing money. Not that there is anything inherently wrong in paying high salaries; Iacocca probably could be making much more money at a much healthier company. But the much heralded sacrifices made by Chrysler executives did not last long--just about long enough to secure federal support for the company.

Myth No. 5: Chrysler's new-found profitability shows that it is on the road to financial recovery.

Chrysler's supporters were elated when the company reported a net profit of over \$170 million in the first quarter of 1983--the largest quarterly profit in the company's history. Lee Iacocca has also announced that the remaining \$800 million in federally guaranteed loans will be repaid by September--seven years ahead of schedule. Many observers call this a "comeback." Rumors of Chrysler's resurrection, however, may be premature.

Chrysler claims that cost cutting has been an important factor in the company's success. But Chrysler's version of cost cutting provides a shaky foundation for long-term profitability. Examples:

- o Carry-forward of tax losses. Chrysler's massive losses in 1979, 1980, and 1981 have given the company large tax deductions to cut its tax bills almost to zero throughout the 1980s. Of the \$170 million "earned" by Chrysler in the first quarter of 1983, only half actually represents operating profit; the other half is attributable to Chrysler's large loss carry-forward.

- o Cuts in research and development (R&D) spending. Chrysler boosted R&D spending from \$161 million in 1972 to \$358 million in 1979 (or \$207 million in 1972-equivalent dollars). But between 1979 and 1982, R&D spending was cut to \$307 million (only \$133 million in 1972 dollars). R&D includes product planning and design for Chrysler's future models. Slashing such outlays may mean quick paper profits at the cost of future innovation and competitiveness.

- o Decreases in capital investment. Industry analysts are concerned that Chrysler is sacrificing long-term capital investment in the interest of short-term profit. "We still have long-term concerns about the company and the fact that during this period of trial and tribulation, they have not spent much money for product, plant, and equipment," says Harvey Heinbach, automobile industry analyst for Merrill Lynch. "This year [1982] Chrysler will have invested \$500 million in capital spending, compared to General Motors' \$8 billion."

o Deferrals of pension costs. In January 1982, Chrysler reached an agreement with the United Auto Workers to defer \$220 million in pension fund contributions. The UAW is not likely to allow deferrals to continue indefinitely.

o Decreases in labor costs. In January 1981, Chrysler negotiated special concessions from the UAW that saved the company more than \$600 million in 1981 and 1982. The union is now fighting to restore those benefits for its workers. After a threatened strike in the United States and an actual strike by Chrysler's Canadian workers in late 1982, Chrysler was forced to give back many of those concessions. More management climb-downs are expected when the current agreement expires in January 1984, and wage parity with General Motors and Ford workers is an avowed goal of the auto workers union and its members. Currently, Chrysler pays two dollars an hour less to UAW workers than do General Motors and Ford. If all of Chrysler's 40,000 hourly workers were paid the union rate, and they worked eight-hour days through the first three months of 1983, then nearly \$40 million would disappear from Chrysler's profit in the first quarter in 1983.

Not all of Chrysler's cost cutting has occurred in these five areas, of course. But these samples illustrate that Chrysler's current profitability--as well as its prospects for future profitability--depends to a large extent upon a set of unique and inherently temporary circumstances.

Myth No. 6: Chrysler's survival has improved America's position in the international automobile market.

One argument made in support of the Chrysler loan guarantees was that it would make it easier for the United States to compete in the world market for cars, since four American companies would be competing in that market instead of three. The following statistics refute this: In 1980, when Chrysler began obtaining its guaranteed loans, Chrysler cars accounted for 7 percent of all automobiles registered in the United States, while other domestic cars accounted for 65 percent, and imported cars accounted for 28 percent. In 1981, when Chrysler received its second "wave" of loans, Chrysler's share increased to 9 percent, imports increased slightly to 29 percent, and other domestic cars slid to 62 percent. Statistics for 1982 generally mirror those of 1981. In other words, Chrysler has increased its market share not by making inroads into foreign competition, but by taking customers away from other domestic manufacturers.

When Chrysler was on the verge of bankruptcy in 1979, the marketplace was signalling that the slackening automobile market would only support three U.S. car manufacturers. By granting the Chrysler loan guarantees, Congress ignored that signal. If Chrysler survives, it will probably mean that the shrinking automobile market will be shared by four ailing domestic automakers, rather than the two or three relatively healthy car manufacturers that would have emerged had Chrysler been allowed to go into formal bankruptcy.

CONCLUSION

When the loan guarantee program was being considered by Congress, Chrysler's unions and top management constituted the "visible" constituency, pleading its case in Washington and begging to be pulled back from the jaws of bankruptcy. Unrepresented and unheard was a huge "invisible" constituency. They included:

- o Current and future laid-off Ford and General Motors workers, who never understood that their tax dollars were being used to destroy their own jobs in order to save jobs at Chrysler;
- o Small businessmen and private individuals, who never understood that the Chrysler bail-out would squeeze \$1.2 billion dollars out of the credit market, making it difficult and more costly for them to raise business capital or finance a mortgage on a new house, all of which would have created new jobs;
- o Over 60,000 now laid-off Chrysler workers, who expected the bailout to save their jobs;
- o American car buyers, who never understood that Ford and General Motors would have taken over much of a bankrupt Chrysler's market and produced cars more efficiently, reducing the cost of domestic automobiles.

The problem with the Chrysler bail-out--in fact, the problem with all "industrial policy"--is that it is necessarily political in nature; the loudest interest groups get the greatest reward, while the scattered and fragmented "invisible constituency" is largely ignored. But a free market is a tangled web of infinite and subtle interaction, in which the full impact of intervention is not always recognized until too late. In the case of the Chrysler bail-out, a big chunk of taxpayer money was committed to a shaky and inappropriate venture. Every American became an involuntary and uncompensated partner in a company whose future is still in doubt. The precedent established is extremely dangerous. On top of this, the bail-out even failed in its purpose.

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