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The Detroit Bailout: Unsafe at Any Cost

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Should Washington bail out Detroit? That is the question facing Congress as it reconvenes this week for a special post-election session. Nearly everyone agrees that, with losses piling up, Detroit automakers need to change the way they operate and change soon. The real issue is how best to do that.

The Detroit-based automakers—General Motors, Ford, and Chrysler—argue that they need more money from U.S. taxpayers. That approach, however, is more likely to extend the status quo rather than lead to reform. A far better approach is to restructure the old-fashioned way, through a formal bankruptcy process if necessary. Bankruptcy—and the prospect of it—would provide both the incentive and means for making the hard and painful choices that Detroit needs to make. Lawmakers should turn down pleas for subsidies that would detour that process.

Varying Proposals. Just last month, U.S. automakers won congressional approval of $25 billion in federal loans for manufacturing cleaner cars at an estimated cost to taxpayers of $7.5 billion.[1] Since that time, however, the financial condition of automakers has worsened, with the Big Three reporting losses in the billions. General Motors has the grimmest news, warning that it could run out of cash within months.

Armed with this bad news, the industry went back to Capitol Hill. Pointing out that the recently approved $25 billion dollop of aid would take months to process, the automakers asked for more and faster aid.

President-elect Barack Obama and congressional leaders such as Speaker Nancy Pelosi (D-CA) have broadly supported more subsidies. The leading proposal now seems to be the provision of $25 billion in federal loans—most likely taken from the $700 billion already allocated to address the financial crisis—although the total may be lowered to reduce opposition. The Bush Administration, for it part, has opposed automaker access to the $700 billion but has supported dropping conditions from the $25 billion already allocated.

Glum Finances. Is the money really needed? There is little doubt that auto manufacturers—or at least some of them—are in real trouble. In October, GM's sales fell 45 percent, Chrysler's fell 34.9 percent, and Ford's dropped 30.2 percent. Non-Detroit companies did not perform much better: Toyota's U.S. sales decreased 23 percent.[2]

But beyond that, there are substantial differences between firms. Each of the three Detroit automakers reported big losses in the third quarter, with General Motors and Ford each reporting losses between $2 billion and $3 billion. Many non-Detroit firms, however, did much better. The largest, Toyota (which is a major manufacturer in the U.S.) still reported a small profit.

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Among Detroit-based firms there are also substantial differences. General Motors is perhaps worst off, reporting that it may have only enough cash to last a few more months. By contrast, Ford, while facing significant threats, is much more optimistic. In fact, CEO Alan Mulally recently asserted: "With the assumptions we have in place, we believe we have sufficient liquidity to make it through this downturn."[3]

Long-Term Problems. GM CEO Rick Wagoner has gone as far to say that "the problems in the auto industry are a direct result of the credit crisis."[4] And no doubt the current economic downturn—and related credit crunch—have contributed to the industry's woes. But the automakers' problems go far deeper than that.

The industry made a number of poor decisions well before the credit crunch that led to their current position. First, Detroit's dependence on big, non-fuel-efficient vehicles was its own doing. The strategy—not shared by rivals such as Toyota—was long a profitable one; for many years SUVs and minivans were a golden goose for the Big Three. But now this strategy is proving costly, as Detroit struggles to shift to more fuel-efficient vehicles.

High costs are also a problem for Detroit's Big Three. The industry's high labor costs are well-documented.[5] But that is only the start. In April, *The Detroit Free Press* reported that GM, Chrysler, and Ford have 15,710 independent dealerships in the United States, compared to roughly 4,000 for all the Japanese dealerships.[6] State laws, dealership contracts, and other factors all contributed to Detroit's crisis.

But high current costs are only part of the problem. So-called "legacy costs" leave Detroit paying an enormous sum of money for mistakes made in the past. In 2004, GM, Ford, and Chrysler employed approximately 370,000 people in their U.S. automotive operations but supported more than 800,000 retirees with expensive pension and health care packages negotiated through collective bargaining.[7] From 1993 to 2007, General Motors alone spent an average of $7 billion per year to fund legacy pensions and retiree health care.[8] These legacy costs create a catch-22 for automakers: Not only are they nearly impossible to trim outside of bankruptcy, but as firms downsize existing operations, they become a proportionately larger burden on the company.

Consequences of a Bailout. Proponents of a bailout argue that taxpayer funding would provide carmakers critical breathing space to address these problems. But that involves more than a little wishful thinking. Many of the needed changes have already been put off for years—more "breathing space" would likely allow them to be put off even longer.

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1. See James L. Gattuso and Nicolas D. Loris, "Putting the Brakes on the Automaker Bailout," Heritage Foundation *WebMemo* No. 2060, September 11, 2008, at *http://www.heritage.org/Research/Budget/wm2060.cfm*.
2. Bill Vlasic and Nick Bunkley, "Automakers Report Grim October Sales," *The New York Times*, November 3, 2008, at *http://www.nytimes.com/2008/11/04/business/04auto.html* (November 16, 2008).
3. Sarah A. Webster, "Ford Will Survive, Mulally says," *The Detroit Free Press*, November 8, 2008, at *http://www.freep.com/article/20081108/BUSINESS01/811080328/?imw=Y* (November 16, 2008).
4. Katie Merx, "GM Grapples to Avoid Filing Bankruptcy as Cash Vanishes," *The Detroit Free Press*, November 8, 2008, at *http://www.freep.com/article/20081108/BUSINESS01/811080331/1014/business01* (November 16, 2008).
5. See, Lawrence Reed and Burton Folsom, "The Downshift at GM," *The Washington Times*, September 18, 2008, at *http://www.washingtontimes.com/news/2008/sep/16/the-downshift-at-gm/* (November 16, 2008).
6. Sarah A. Webster, "Excess Dealers Costing Billions," *The Detroit Free Press*, April 17, 2008 at *http://www.freep.com/apps/pbcs.dll/article?AID=/20070617/BUSINESS01/104170005/1002/business* (November 16, 2008).
7. Stephen Cooney, "Comparing Automotive and Steel Industry Legacy Cost Issues," Chicago Federal Reserve, November 28, 2005, at *http://chicagofed.org/news_and_conferences/conferences_and_events/files/2006_auto_cooney2.pdf* (November 16, 2008).
8. Roger Lowenstein, "Siphoning G.M.'s Future," *The New York Times*, July 10, 2008, at *http://www.nytimes.com/2008/07/10/opinion/10lowenstein.html?ei=5124&en=5c8dbae642633489&ex=1373342400&partner=permalink&exprod=permalink&pagewanted=print* (November 16, 2008).

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Moreover, no matter what stern public warnings policymakers issue with the cash—for example, urging carmakers to restructure—there will doubtless be unwritten political "no fly" zones. One can just see the headlines: "Government Funds Job Cuts," "Taxpayer Money Funds Dealership Closings." Put bluntly, the types of changes that are needed will be painful and unpopular, and it is difficult to imagine politicians allowing them, never mind insisting on them.[9]

The Bankruptcy Option. There is an alternative method of facilitating needed restructuring: bankruptcy. While often seen as a sign of failure, the bankruptcy process is often the best way for troubled enterprises to get back on their feet. Debts are reduced or cancelled and contracts terminated or renegotiated, allowing firms to get a fresh start. And if a firm still cannot be made viable, bankruptcy also provides for an orderly and clear process for getting assets—including plants and equipment—back into productive use by others.

There are, of course, losers under bankruptcy. Management is more likely to be replaced, but that might be deserved. Shareholders lose their investment, but stock values are plummeting already.

This is not to say that bankruptcy is necessary for every firm. Ford, for instance, is still expressing confidence that it make its way through without it. Chrysler, the smallest of the three Detroit firms, could possibly be merged with stronger partner, such as Nissan. But if other options fail, bankruptcy is a natural and practical choice.

Some argue that a declaration of bankruptcy would, in itself, drive auto customers away by raising concerns that crucial post-sale warranty service would not be available. But the auto firms have hardly kept their woes a secret. The word is already out. Rather than spawn concerns, a bankruptcy proceeding could actually reduce such worries by providing a path to recovery.

The most sweeping argument against bankruptcy is that the automakers are just too big to fail, citing the millions of people employed by the Big Three automakers and by firms dependent on them. But bankruptcy does not mean an end to operations: Firms routinely continue operations while in the bankruptcy process. Moreover, even the worst-case scenario—liquidation—does not mean vaporization. The assets of a firm do not vanish. Rather, they are resold to others more able to make productive use of them.[10]

Of course, jobs will still be lost. But Detroit will almost certainly have to shrink under any viable restructuring plan. And in the longer run, addressing the hard questions and making the hard choices—rather than postponing them through taxpayers bailouts—will lead to more jobs and a better economy.

Delaying the Inevitable. The Detroit automakers are in trouble. While perhaps triggered by current economic downturn, the crisis has been long in the making, fed by bad business decisions and failures to control costs. The industry needs to change and change quickly, on its own if possible, through bankruptcy if necessary. Yet, the remedy proposed by these firms—ever more taxpayer cash—will only delay that change. Whatever the cost, subsidy is an unsafe course for consumers, the industry, and the U.S. economy. Congress must say "no." If it does not, President Bush should have his veto pen at the ready.

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9. Some have suggested that needed reforms be mandated as a condition of accepting funding. However, this assumes that policymakers know exactly what is needed to make a firm profitable. Rather than mitigate problems, such government control over business decision-making would only compound it.
10. For a fuller discussion of the bankruptcy option, see Andrew M. Grossman, "Automakers Need Bankruptcy, Not Bailout," Heritage Foundation *Legal Memorandum* No. 33, November 15, 2008, at *http://www.heritage.org/Research/Economy/lm33.cfm*.