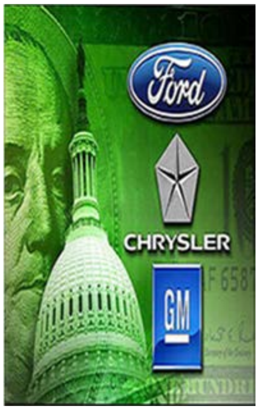
BRIEF ASSIGNMENT #4: **Bailout or Bankruptcy?**



Lemon or Lemonade?
Reasons Against the Bailout

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The New American
January 5, 2009

There is no question that the Big Three automakers--General Motors, Ford, and Chrysler--are in financial trouble. They are burning through billions just to continue operating, even as they face a tightening credit market, plummeting share values (between 70-and 82-percent drops over the last year, with GM currently worth less than toy maker Mattel), and a dramatic slump in sales--the worst in decades. In addition, sales of the highly profitable but gas-guzzling SUV's have been in steep decline since the surge in gasoline prices, dealing another revenue blow to the beleaguered automakers.

The Big Three are claiming that their companies are too big to be allowed to fail, and are predicting the doom of the American economy in the absence of a government rescue plan. Many financial experts agree and predict that a Big Three bankruptcy would be a risky scenario not just for the industrial heartland, but for the country as a whole. However, handing over $25 billion to U.S. automakers may be a short-term national benefit — but it would only draw out Detroit's slow slide to failure, with no return on the public's investment. On the other hand, allowing Detroit's free-fall into bankruptcy might be painful for the nation in the short run, but would offer the best route to industry revival over the long haul.

First, there are economists who argue that as large as the automakers are, they don't pose nearly the risk to the economy as does Wall Street and the nation's banks. Together, the Big Three automakers have about $75 billion in debt related to their automotive operations. That's only a fraction of the trillions of dollars in mortgage backed securities, credit default swaps and other damaged financial assets that prompted the Wall Street bailout package. "It's not a systemic risk with the automakers," said David Wyss, chief economist with Standard & Poor's. "It's a big problem if you live in Michigan. But there isn't going to be a shortage of automobiles or even auto parts if one of them goes out of business. It's fundamentally different from the financial markets. When financial markets go, they affect everybody else.

GM is projected to exhaust its cash reserves by the end of 2009. Ford's cash will last into 2010. Chrysler is already assumed to be lost. The three companies argue that they have already taken steps to become more competitive and that they only need federal money to bridge the current, freak financial crisis so that its cost reforms can go into effect. The companies are correct up to a point.

There are other problems. The United Auto Workers contract doesn't allow American car companies to lay off workers. Idle UAW members receive nearly full pay until new jobs open up or the contract comes to an end. The only way to cut staff is to buy workers out. In recent years, each company has trimmed its union work force by the tens of thousands. GM went from 107,000 UAW members in 2004, the year before its string of losses began, to about 64,000 today.

Another huge cost was health care, for which the Big Three paid billions more than their overseas rivals. Japanese automakers are helped by the fact that their workers back home are covered by a government-paid health care system. What's more, U.S. employees at Japanese companies located in America are generally much younger than their UAW counterparts at the Big Three's plants, and thus have lower health care costs.

But the biggest difference is the hundreds of thousands of retirees at GM, Ford and Chrysler - along with their surviving spouses and other dependents - who had been promised health care coverage. That coverage cost GM $3.3 billion in 2007 alone.

Critics such as columnists Robert Samuelson and Charles Krauthammer are not entirely correct in saying that American automobile industry's hourly labor costs are $25-per-hour higher ($73 v. $48) than their Japanese competitors. In fact, the U.S. automakers won important concessions from the UAW in the 2007 labor deal, including an agreement to shift retiree health care costs to union-controlled trust funds a "two-tier" wage scale that reduces employee costs to $55 per hour — within striking distance of non-union Japanese plants

But striking distance isn't enough, and industry analysts agree that American car companies must do more. The extra wage and benefits burden is still estimated to be more than $2,000 per car. Think what that means: Ford, for example, needs to cut $2,000 worth of features and quality out of its cars to compete with Toyota. Of course the Toyota feels like a better product, it has $2,000 more put into it.

Government regulation and taxation have also harmed the automobile companies. GM paid $37 billion in Michigan's state corporate taxes in 2007, and that doesn't include federal taxes. Foreign competitors pay what's called a Value Added Tax (VAT) on each vehicle sold, which works against the American companies. For instance, German car companies pay a 19-percent VAT, but this entire tax is reimbursed to the companies if they export the vehicle. If an American car is sold in Germany, the VAT gets added to the American car, making it even harder for double-taxed American companies to compete overseas. The Tax Foundation argues that instead of a bailout, what the Big Three need is simple tax relief.

Senator John Ensign commented: "We are in the midst of a recession, yet we have come back for a late session of Congress to talk about saving just three companies. Why aren't we considering pro-growth policies to help the larger economy? We should be considering long-term, pro-growth tax cuts rather than searching for ways to spend more of the taxpayers' money. For instance, lowering the corporate tax rate would put more money back in the hands of companies all across America. This would help companies stay afloat and to avoid cutting jobs during these difficult times."

In the past, the American auto giants could just pass all the added expenses on to the consumer, but with competition in the industry becoming increasingly more fierce and international, regulations and taxes passed in Washington in better years seem to be unsustainable if the Big Three hope to remain competitive.

Thirty years ago, the federal government successfully bailed out Chrysler Corp. But today’s landscape looks very different from that of the late 1970s. At that time, the Big Three’s Japanese competitors did not operate a single manufacturing facility in the U.S. Today, Japanese, German, and Korean manufacturers all operate plants here — employing 402,800 American workers from Kentucky to Alabama with an average annual wage of $63,538.

At the head of the line of stands Toyota. In its 2008 fiscal year, it earned a remarkable $17.1 billion world-wide and assembled 1.66 million motor vehicles in North America. Toyota has production facilities in seven states and R&D facilities in three others. Honda operates in five states and earned $6 billion in net income in 2008. In other words, a bailout for a Detroit company is no longer essential for maintaining America’s auto-manufacturing base.

In contrast to Toyota and Honda, General Motors lost $38.7 billion last year. Writing for the Wall Street Journal, Michael Levine of NYU’s School of Law points out that GM and its chief competitor, Toyota, have nearly identical U.S. market share (20 percent for GM, 19 percent for Toyota). Yet GM has eight brands and Toyota only three. GM also had 7,000 dealers (due to state franchising laws) versus only 1,500 for Toyota.

It is an open secret in the Motor City that even leaving aside its high labor costs, surplus of brands, and bloated dealer network, the American automobile industry’s manufacturing culture is inefficient compared to foreign rivals Toyota and Honda. Production runs for Detroit automakers are frequently interrupted to change specifications. Those interruptions add costs that Japanese manufacturers rarely incur. The problem is so prevalent that employees for Johnson Controls, Inc., a major international parts supplier, often joke that their acronym stands for “Just Change It” because its American clients routinely run up unnecessary costs by altering production contracts. These problems cry out for restructuring, yet GM insists on postponing hard decisions hoping instead for an infusion of taxpayer booty.

In their appeal to taxpayers for $25 billion, GM, Ford, and Chrysler arrogantly refused to provide a revised business plan in return for the money. Instead, they played the fear card, arguing that withholding the funds will lead to a national depression.

Can a $25 billion taxpayer bailout help General Motors change its culture?

“No,” says one executive. “You have to burn them down and start over.”

Worse still, federal cash will come with strings attached, thanks to a Congress that wants to turn Detroit into ground zero in its battle against global warming. The result would be government imposed targets forcing automakers to make more “green” cars whether there is market demand for them or not. Absent structural reforms, mandating money-losing small cars would only hasten Detroit’s demise.

Considering all these disadvantages, any bailout for the Big Three will only delay the inevitable. While corporate and union executives predict the demise of the industry and more dire news for the economy if they have to file for bankruptcy, others with direct knowledge of the industry say that bankruptcy may be the only way to save the industry. Former Republican presidential candidate Mitt Romney, whose father remarkably resuscitated American Motors from the brink of collapse in the 1950s, blasted the bailout in the New York Times. According to Romney: "Bankruptcy may be the only path to the fundamental restructuring the industry needs. It would permit the companies to shed excess labor, pension and real estate costs." Many analysts point to past bankruptcies in the airline industry as a precedent for successful reorganization of large corporations. Bankruptcy would be painful, but it would also be the transformational moment that U.S. automakers have needed for far too long.

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