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**Before the Committee on Oversight and Government Reform
Subcommittee on Regulatory Affairs, Stimulus Oversight
and Government Spending**

U.S. House of Representatives

June 22, 2011

Chairman Jordan, Ranking Member Kucinich, and members of the subcommittee, thank you for inviting me to address you about this important matter. My name is Shikha Dalmia and I am a senior analyst at Reason Foundation, a non-profit think tank that researches the consequences of government policy, works to advance liberty, and develops ways the free market can be leveraged to improve the quality of life for all Americans. I have lived in the metro Detroit area for the last 23 years, working for 10 of those on the editorial board of the *Detroit News* followed by Ford Motor Credit Company in 2005 before joining Reason Foundation where I have written extensively about the auto industry for major newspapers such as the *Wall Street Journal*, *Los Angeles Times*, *Forbes* and *The Daily*.

Nine years ago, my husband and I spent a large portion of our nest egg building a house in West Bloomfield, a suburb of Detroit, the mainstay of whose economy is the auto industry. A few years later, the Big Three entered a downward spiral, and along with it home values in our area. If we were to sell our house now, it would be at a price significantly below what it cost us to build it. Our fate is very much tied to that of the auto industry and hence we are among the region's hundreds of thousands of homeowners who are rooting for the Big Three. However, although I am cheered by the return to profitability of Detroit's automakers, I don't think that the \$95 billion or so that taxpayers spent to bail out GM and Chrysler has positioned the companies for future success. Nor was it worth the long-term cost to the broader American economy. Taxpayers stand to lose \$28 billion to \$34 billion of the bailout amount. But that's just the tip of the iceberg. There are at least four hidden costs that will plague the U.S. economy in the years and decades to come.

Undermining the Rule-of-Law in Bankruptcy

This, in my view, is in some ways the most unfortunate aspect of the bailout because it was the most avoidable. One of the main arguments for the bailout was that GM and Chrysler didn't have the cash on hand nor could they raise it from moribund financial markets to finance a Chapter 11 bankruptcy. (Chapter 11 bankruptcy allows companies to restructure their balance sheets by shedding their liabilities to creditors and employees and make a fresh, clean start.) Hence, if the government did not step in and bail out the companies, they would essentially face Chapter 7 bankruptcy or liquidation. This would mean that they would be shuttered, their assets sold off, disrupting the auto supply chain, costing tens of thousands of jobs and

dumping millions of retirees on to the government's Pension Guaranteed Benefit Program.

Although liquidation might have been in the realm of possibility for Chrysler, many experts, including Todd Zywicki, a bankruptcy expert at George Mason University, highly doubt that GM would have faced liquidation. That's because the company was financially distressed—after years of poor management—but not economically unviable. If GM had put together a credible restructuring plan, it would have been able to obtain debtor-in-possession financing under which, as the name suggests, the debtors would have essentially possessed the company. This means that once GM returned to profitability, the debtors would have claimed first dibs on being paid. If the company had been unable to obtain this DIP financing from the private market, the government could have helped by guaranteeing the private lenders the loaned amount, which, in all likelihood, would have been far smaller than the bailout amount.

The government should then have let longstanding bankruptcy law determine how much of a loss the various stakeholders—unions, lenders, shareholders—would suffer.

Instead, the administration essentially wrote its own bankruptcy rules, throwing out established precedent. For example, consider what it did to Chrysler. Normally, secured creditors, meaning creditors to whom a company has offered a piece of its assets in exchange for a loan, are paid back on a priority basis in bankruptcy proceedings. But under the government bailout, Chrysler's secured creditors received 29 cents on the dollar. By contrast, its unions were paid 40 cents on the dollar even though their claims against the company are equivalent to those of low-priority, unsecured creditors.

Another example is that, in a normal bankruptcy, secured creditors who are not paid in full are entitled to a "deficiency claim"—meaning that the bankrupt company has to pay back at least a portion of what they are owed at a later date. Chrysler and GM creditors received no such right.

Likewise, under typical bankruptcy, a company is not allowed to take a tax write off of its old debts against the profits of the new, restructured company. But GM will be allowed to deduct up to \$45 billion of its previous

losses from its future profits, something that works out to about \$14 billion in tax savings for GM that its competitors don't enjoy.

Such flouting of bankruptcy law essentially signals to future lenders that should they loan money to private companies, they can't count on the standing rule-of-law to protect them. They can't know the full risks of such loans because the rules could change for political reasons at any time. The government may step in and rearrange creditors' normal priorities in order to reward favored stakeholders while giving them the short-end of the stick. This might make it harder, not easier, for such industries to obtain private credit going forward, increasing the need for government—or, rather, taxpayer—assistance. In effect, the government would crowd out private credit markets.

The Opportunity Cost of the Bailout

One of the ironies of the bailout is that it constitutes a missed opportunity, not a second chance for GM and Chrysler. At best, it has prepared these companies to compete with the industry leaders of yore rather than those of the future.

American automakers had been losing market share to foreign competitors even before the current recession began. One big reason is their uncompetitive labor costs. Bankruptcy should have been an opportunity for them to significantly rationalize their obligations to labor, clean-up their balance sheets and start afresh. Although GM managed to negotiate lower wages and benefits, it did not get meaningful relief from its legacy costs. Under normal bankruptcy rules, UAW, as an unsecured debtor, would have had to forgo most of its pension and health care claims. That didn't happen in this case, so the company has unfunded pension obligations to the tune of \$27 billion whose bill is due in 2014. This will be a major drag for the company going forward, and may only have delayed the inevitable day of reckoning for these companies.

GM and Chrysler's post-bankruptcy labor costs are \$58 an hour—compared to \$70 an hour pre-bankruptcy. This is comparable to Toyota's labor costs of \$56 an hour. But Toyota no longer sets the industry's cost curve. Smaller Asian firms such as Hyundai and Kia whose labor costs are \$40 an hour do. (Kia's sales volume has climbed 45 percent this year, the fastest pace among

the 10 largest automakers in the U.S.). It is an open question whether GM can compete with the Kias of the future.

In contrast to the American auto industry, consider the experience of the U.S. steel industry that did not receive a major bailout. Until about 1945, Big Steel—consisting of companies such as U.S. Steel that produced steel from iron ore in large mills—dominated the world market, producing about half of the global steel output. This hegemony, notes University of Dayton economic historian Larry Schweikart, led the industry to precisely the same problems facing the Detroit-based car makers today: bloated corporate bureaucracies; a pampered, unionized workforce with unsustainable legacy costs; and inefficient production methods.

By the 1960s, Big Steel was facing stiff competition from overseas producers, first from Japan and Europe and then from Third World countries such as Brazil. About a quarter of American steel producers went bankrupt between 1974 and 1987. The industry's global market share shrank to 11 percent and employment dropped from 2.5 million in 1974 to 1 million in 1997. But this fight for survival, spanning decades and several recessions, eventually restored the overall industry to profitability. Led by companies such as Nucor, domestic steel makers discovered new ways to turn scrap into steel in sleeker, smaller factories called "mini-mills," using workers who are paid competitive wages and a leaner management team.

But beyond the missed opportunity for GM and Chrysler, there are other opportunity costs for the auto industry and the economy as a whole. Without the bailout, these companies would have carried on in some form, but they would have looked very different from what they do right now. It is always tricky to draw up counterfactuals, but it is possible that GM and Chrysler might have merged into one, eliminating excess capacity in the industry while pooling together their expertise and resources to form a more viable unified entity. This was a possibility that both had actively considered before the federal government handed them taxpayer dollars to keep them afloat as separate entities.

Alternatively, it is also possible that other automakers or automotive entrepreneurs might have purchased GM and Chrysler's more viable brands and run them as independent companies. For example, Roger Penske, owner of the Penske Automotive Group Inc., a Michigan-based auto supplier, tried unsuccessfully to put together a plan to buy the Saturn brand from GM.

Others might have stepped in if the government hadn't intervened, replacing the few, large, vertically integrated players with a myriad smaller, more efficient ones. The excess workers and resources released in the process would have been absorbed by other industries, diminishing their costs and increasing the overall efficiency of the economy. To return to the example of the steel industry, the physical and human resources that the steel industry squeezed out in its quest for more efficiency didn't simply go up in smoke. They were utilized by other sectors of the economy. For example, employment in the plastic industry, which replaced steel for some uses, grew over 18 percent between 1980 and 2006. We will never know what new industries the auto bailout might have strangled in the crib.

The bailout has further entrenched the status quo in the auto industry instead of exposing it to the winds of creative destruction that have made other sectors of the American economy so dynamic and resilient.

The Moral Hazard of the Bailout

Another big problem with the bailout is that it might well have unleashed a systemic moral hazard that fundamentally weakens America's market-based economy. In the two years prior to the bailout between 2007 and 2009, GM had accrued \$70 billion in losses, thanks to an unwieldy and bloated operation that supported eight brands, many of them money losers. It had amassed a debt that was 24 times its market capitalization. Yet it had no cash on hand for product development or to weather a rainy day. By contrast, in those two years, Ford laid off workers, sold money-losing brands such as Jaguar Land Rover and Aston Martin, and mortgaged all its assets—including its logo, the Blue Oval—to build \$25 billion in reserves that it invested in product development and for use in an economic downturn.

But the bailout rewarded GM's irresponsible, reckless behavior and penalized Ford's prudent, forward-looking one. It handed GM an undeserved edge vis-à-vis its competitors, especially since the vast bulk of the bailout amount was given to it through the purchase of equity rather than a loan. This relieved GM from debt service costs that consumed \$251 billion of Ford's revenues last year.

Given such a precedent, any company that feels that it is too big to fail or is regarded as a national icon or is deeply enmeshed in the broader US economy or is a major regional employer will wonder whether it makes

more business sense for it to save for an economic downturn or holdout for taxpayer assistance. It will introduce a consideration in the business planning of companies that has nothing to do with enhancing their efficiency or consumer welfare. It will encourage unnecessary risk-taking and undermine the U.S. economy.

And should the companies seek government help, the government will find it harder and harder to refuse. Indeed, just as the Wall Street bailout became a justification for the auto bailout, the auto bailout will become a justification for future bailouts of other industries. For example, it will be very hard to justify to West Virginia steel mills, should they ever find themselves in economic trouble, why they are less deserving of a bailout than Michigan's auto industry.

The Bailout Has Legitimized Increased Government Management of Private Companies

The one who pays the piper calls the tune, they say. And so it is with the bailout. Government help means government control. Therefore, despite the administration's protestations that it had no interest in running GM or Chrysler, the fact of the matter is that the goals of the bailout are not identical with those of returning the companies' to profitability and hence there has been a great deal of political meddling in the day-to-day operations of the companies in the name of protecting jobs, taxpayer "investment" and so on.

For example, the *Wall Street Journal* has extensively documented what a huge role politics played in determining which and how many dealerships the companies could shutter. Likewise, GM was not allowed to replace its Montana supplier of the mineral palladium with a cheaper one from overseas because that would have meant that the bailout dollars were going to prop up businesses abroad rather than those at home, defeating the bailout's stated purpose.

One particularly egregious example of what can go wrong when the government involves itself in the management of a private company was uncovered through a FOIA request by the Competitive Enterprise Institute. It found that GM's TV ad campaign last year that misleadingly claimed that the company had paid back its government loan in full was approved by the administration. The FOIA uncovered e-mails between GM CEO Ed

Whitacre and various Treasury and other federal officials a month in advance of GM's announcement. These emails included draft schedules, draft remarks to be given by Mr. Whitacre, and draft press releases from both GM and the Treasury Department.

The bailout has opened the door for a kind of direct government involvement in private business that makes a mockery of the constitutional scheme of a government of limited and enumerated powers. Ultimately, this might be the most damaging legacy of the bailout, because it inevitably rewards narrow, powerful, politically-favored interests at the expense of American consumers and taxpayers. The bailouts may or may not save GM and Chrysler. But they have created many bad incentives that will distort our economy and system for years to come.

Thank you for the opportunity to discuss this important issue with you. I look forward to answering any questions.