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before the

**Subcommittee on Regulatory Affairs, Stimulus Oversight and Government Spending
Committee on Oversight and Government Reform
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Lasting Implications of the General Motors Bailout

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Introduction

It is galling to hear administration officials characterize the auto bailouts as "successful." The word should be off-limits when describing this unfortunate chapter in U.S. economic history. At most, bailout proponents and apologists might respectfully argue—and still be wrong, however—that the bailouts were necessary evils undertaken to avert greater calamity.

But calling the bailouts "successful" is to whitewash the diversion of funds from the Troubled Assets Relief Program by two administrations for purposes unauthorized by Congress; the looting and redistribution of claims against GM's and Chrysler's assets from shareholders and debt-holders to pensioners; the use of questionable tactics to bully stakeholders into accepting terms to facilitate politically desirable outcomes; the unprecedented encroachment by the executive branch into the finest details of the bankruptcy process to orchestrate what bankruptcy law experts describe as "Sham" sales of Old Chrysler to New Chrysler and Old GM to New GM; the costs of denying Ford and the other more deserving automakers the spoils of competition; the costs of insulating irresponsible actors, such as the United Autoworkers, from the outcomes of an apolitical bankruptcy proceeding; the diminution of U.S. moral authority to counsel foreign governments against similar market interventions; and the lingering uncertainty about the direction of policy under the current administration that pervades the business environment to this very day.

In addition to the above, there is the fact that taxpayers are still short tens of billions of dollars on account of the GM bailout without serious prospects for ever being made whole. Thus, acceptance of the administration's pronouncement of auto bailout success demands profound gullibility or willful ignorance. Sure, GM has experienced recent profits and Chrysler has repaid much of its debt to the Treasury. But if proper judgment is to be passed, then all of the bailout's costs and benefits must be considered. Otherwise, calling the bailout a success is like applauding the recovery of a drunken driver after an accident, while ignoring the condition of the family he severely maimed.

This testimony provides a more comprehensive assessment of the costs and lasting implications of the GM bailout than the administration has been willing to undertake publicly.

Crisis Mongering

On November 5, 2008, the Center for Automotive Research, a Detroit-based consulting firm, released the results of a study warning that as many as 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.[1] Detroit's media blitz was underway. It was timed to remind then-President-Elect Obama, as he contemplated his victory the morning after, of the contribution to his success by certain constituencies now seeking 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 Detroit auto producers, then the foreign nameplate U.S. producers and the rest of the parts supply chain. The job loss projections animating the national discussion were based on an assumption of a total loss of all automobile and auto parts production and sales jobs nationwide. Importantly, the report gave no consideration to the more realistic scenario that one or two of the Detroit automakers might seek Chapter 11 protection to reorganize.

The subsequent public relations effort to make the case for federal assistance was pitched in a crisis atmosphere with an air of certainty that the only real alternative to massive federal assistance was liquidation and contagion. The crisis-mongering was reminiscent of former-Treasury Secretary Henry Paulson's and Federal Reserve Board Chairman Ben Bernanke's insistence six weeks earlier that there was no time for Congress to think, only time for it to act on a financial sector bailout (i.e., TARP), lest the economy face financial ruin.

About the economic situation at that time, incoming White House Chief of Staff Rahm Emanuel said, "You never want a serious crisis to go to waste … [t]his crisis provides the opportunity for us to do things that you could not do before."[2]

The mainstream media obliged the script, elevating the automobile industry "crisis" to the top of the news cycle for the next month, and helping to characterize 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, and the specific facts about viability and worthiness were all but totally ignored.

But public opinion quickly changed when the CEOs of GM, Ford, and Chrysler laid waste to months of public relations planning and millions of dollars spent trying to cultivate a winning message when they each arrived in Washington, tin cups in hand, aboard their own corporate jets. That fateful episode turned the media against Detroit and reminded Americans — or at least

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[1] David Cole, Sean McAlinden, Kristin Dziczek, Debra Maranger Menk, "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers," Center for Automotive Research Memorandum, November 4, 2008, available at http://www.cargroup.org/documents/FINALDetroitThreeContractionImpact_3__001.pdf

[2] Gerald Seid, "In Crisis, Opportunity for Obama," *Wall Street Journal*, November 21, 2008. http://online.wsj.com/article/SB122721278056345271.html

opened their minds to the prospect — that the automakers were in dire straits because of bad decisions made in the past and helped convince many that a shake out, instead of a bailout, was the proper course of action.

A few weeks later, on the same day that the CEOs returned to Washington, attempting to show contrition by making the trip from Detroit in their companies' most eco-friendly cars, 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 newest facility in the American heartland spoke volumes about the true state of the U.S. car industry—and provided another example of why the bailout was misguided. The U.S. auto industry was not at risk. Two companies were suffering the consequences of years of incompetence and inefficiency exacerbated by persistent overcapacity and a deep recession. Normal bankruptcies for the two automakers were viable options, but certain stakeholders didn't like their prospects under those circumstances.

Today, when President Obama contends that his administration saved the auto industry, he evokes memories of those CAR projections of 2-3 million job losses in the absence of government intervention. Without those inflated figures concocted during a time of "crisis," the 225,000 jobs lost in the auto sector since November 2008 seem quite mild—even worthy of praise.[3]

That Which is Seen

While bailout enthusiasts hail GM's first-quarter earnings as proof that the administration saved the auto industry, President Obama should know better than to gloat. No such feat was accomplished and the imperative of extricating the government from GM's operations has yet to be achieved.

With profits of $3.2 billion, the first quarter of 2011 was GM's best performance in ten years and its fifth-consecutive profitable quarter. That's good for GM, and predictably those earnings have been hailed by some as a validation of government intervention. The *Washington Post's* E.J. Dionne asserted: "Far too little attention has been paid to the success of the government's rescue of the Detroit-based auto companies, and almost no attention has been paid to how completely and utterly wrong opponents of the bailout were when they insisted it was doomed to failure."

Former Michigan governor Jennifer Granholm tweeted: "To all of you in the strangle-government crowd, who said the bailout would never work — I'm just sayin."

Dionne and Granholm have created a straw man, contending that bailout critics thought that the government couldn't resuscitate GM. But the most thoughtful criticism of the bailout was not predicated on the notion that GM couldn't be saved by the government marshaling the vast

[3] At an event in Toledo, Ohio in May, President Obama said, "Supporting the American auto industry required tough decisions and shared sacrifices, but it helped save jobs, rescue an industry at the heart of America's manufacturing sector, and make it more competitive for the future." http://www.whitehouse.gov/blog/2011/05/27/another-big-week-american-auto-industry. Auto jobs figures come from the Bureau of Labor Statistics.

resources at its disposal. That opposition was borne of concern that that the government would do just that, and in the process impose many more costs and inflict greater damage. And that's what it did.

But Dionne and Granholm, like others before them, stand slack-jawed, in awe, ready and willing to buy the Brooklyn Bridge, donning blinders and viewing just a narrow sliver of the world, oblivious to the fact that related events have been transpiring in the other 359 degrees that surround him. They are the perfect Bastiat foils, incapable of discerning the costs that are not immediately apparent.[4]

But only the most gullible observers would accept GM's profits as an appropriate measure of the wisdom of the auto bailout. Those profits speak only to the fact that politicians committed over $50 billion to the task of rescuing a single company. With debts expunged, cash infused, inefficiencies severed, ownership reconstituted, sales rebates underwritten, and political obstacles steamrolled — all in the midst of a cyclical U.S. recovery and structural global expansion in auto demand — only the most incompetent operation could fail to make big profits. To that point, it's worth noting that more than half of GM's reported profit — $1.8 billion of $3.2 billion — is attributable to the one-time sales of shares in Ally Financial and Delphi, which says nothing about whether GM can make and sell automobiles profitably going forward.

In the process of "rescuing" GM, the government opened a Pandora's Box. Any legitimate verdict on the efficacy of the intervention must account for the costs of mitigating the problems that escaped the box.

That Which is Not Seen

Spoils of Competition Denied – Market Process Short-Circuited

The intervention on GM's behalf denied the spoils of competition — the market share, sales revenues, profits, and productive assets — to Ford, Honda, Hyundai, and all of the other automakers that made better products, made better operational decisions, were more efficient, or were more responsive to consumer demands than GM, thereby short-circuiting a feedback loop that is essential to the healthy functioning of competitive market economies.

Corporate bailouts are clearly unfair to taxpayers, but they are also unfair to the successful firms in the industry, who are implicitly taxed and burdened when their competition is subsidized. In a properly functioning market economy, the better firms—the ones that are more innovative, more efficient, and more popular among consumers—gain market share or increase profits, while the lesser firms contract. This process ensures that limited resources are used most productively.

It has been suggested that I view GM's fate as a matter of national indifference. That's correct, because I have not made the mistake of conflating GM's condition with that of the U.S. auto industry. Whether or not there are so-called "national interests" in ensuring the existence of a healthy domestic auto industry (and I'm not convinced there are), health comes through an

[4] See Frederic Bastiat, "That Which is Seen, and That Which is Not Seen," 1850, http://bastiat.org/en/twisatwins.html

evolutionary process in which the companies that have made the right decisions survive and grow, and those that have made bad decisions contract and sometimes even disappear.

It is not only fair, but efficient and wise that the market rewards companies that make better products at better prices with higher profits and larger market shares, while the companies that make undesirable products at high cost lose profits and market share.

There is still enormous overcapacity in the U.S. auto industry, reconciliation of which the bailout of GM (and Chrsyler) has deferred at great cost to the other firms and their workers.

Weakening of the Rule of Law

Although legislation to provide funding for an auto bailout passed in the House of Representatives 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 the proper course of action for GM and Chrysler, reorganization under Chapter 11, appeared imminent. An interventionist bullet, seemingly, had been dodged.

But then, just days after then-Secretary Paulson claimed to have no authority to use TARP funds to support the auto companies, President Bush announced that he would authorize bridge loans from the TARP of $17.4 billion to GM and Chrysler. That opened the door to further mischief and, ultimately, another $60 billion was diverted from TARP by the Obama administration for unauthorized purposes related to the auto bailout.

Likewise, the Obama administration treated the GM (and Chrysler) bankruptcy as a Section 363 sale, which are known among bankruptcy lawyers as "Sham" sales. These 363 sales are intended to sell assets out of bankruptcy from one company to another, but are not intended as vehicles to facilitate entire corporate restructurings. In a reorganization process, all creditors are given the right to vote on the proposed plan, as well as the opportunity to offer competing reorganization plans. A 363 asset sale has no such requirements, and is being used increasingly by companies seeking to avert paying legitimate claims to creditors.

That the U.S. executive branch would pretend that the restructuring of GM was nothing more than an asset sale and deny creditors the right to vote or to offer competing bids wreaks of crony capitalism.

Though it is a difficult cost to quantify, executive branch overreach—to put it mildly—is a threat to the U.S. system of checks and balances and an affront to the rule of law.

Executive Encroachment into Bankruptcy Process

General Motors was a perfectly viable company that could have been restructured through normal bankruptcy proceedings. The big question was whether GM could have received financing to operate during bankrupt, given the problems in credit markets in 2008 and 2009. Instead of commandeering the bankruptcy process as a condition of providing debtor in possession financing, the Obama administration could have provided the funds and allowed an

apolitical, independent bankruptcy process to take place. But the administration's rationale for a hand-on approach was that it wanted to ensure that taxpayers weren't just throwing good money after bad, chasing empty promises made by executives with credibility problems. Yet, even with the administration's plans for GM's post-bankruptcy ownership thrust upon the company without allowance for consideration of competing plans, taxpayers will lose between $10-20 billion (without considering the $12 to $14 billion costs of the unorthodox tax breaks granted GM by the administration).

The administration's willingness to insulate important political allies, like the UAW, from the consequences of their decisions, to shift possession of assets from shareholders and debt-holders to pensioners, and to deny "deficiency" claims to creditors who were short-changed, will make it more difficult for companies in politically important industries to borrow from private sources when they are in trouble, thereby increasing their reliance on the government purse.

The government's willingness to intervene in the auto market under false pretenses to pick winners and losers is a significant cause of the regime uncertainty that has pervaded the U.S. economy, deterred business investment and job creation, and slowed the economic recovery ever since.

Outstanding Financial Costs

As Washington has been embroiled in a discussion about national finances that features figures in the trillions of dollars, one might be tempted to marginalize as paltry the sum still owed taxpayers from the GM bailout. That figure is estimated to be about $27 billion, which accounts for the $50 billion outlay minus approximately $23 billion raised at GM's IPO last November. But that is a very conservative figure considering that it excludes: $12-$14 billion in unorthodox tax breaks granted to GM in bankruptucy; $17 billion in funds committed from the TARP to GM's former financial arm GMAC (which was supported to facilitate GM sales); GM's portion of the $25 billion Energy Department slush fund to underwrite research and development in green auto technology; and the $7,500 tax credit granted for every new purchase of a Chevy Volt. There may be other subsidies, as well.

With respect to GM, taxpayers are on the line for much more than is commonly discussed.

The administration wants to put maximum distance between the episode of GM's nationalization and the 2012 campaign season, which is nearly upon us. In that regard, the administration would like to sell the Treasury's remaining 500 million shares as soon as possible. But the administration would also like to "make the taxpayers whole." The problem for the president on that score is that the stock price — even with all of the happy news about the auto industry turnaround — isn't cooperating. As of this morning, GM stock is hovering just under $30 per share. If all of the 500 million remaining publicly-owned shares could be sold at that price, the Treasury would net $15 billion. Add that to the $23 billion raised from the initial public offering last November, and the "direct" public loss on GM is about $12 billion — calculated as a $50 billion outlay minus a $38 billion return. (And not considering all of the extra costs identified above.)

To net $50 billion, those 500 million public shares must be sold at an average price of just over $53 — a virtual impossibility anytime soon. Why? The most significant factor suppressing the stock value is the market's knowledge that the largest single holder of GM stock wants to unload about 500 million shares in the short term. That fact will continue to trump any positive news about GM and its profit potential, not that such news should be expected.

Projections about gasoline prices vary, but as long as prices at the pump remain in the $4 range, GM is going to suffer. Among major automakers, GM is most exposed to the downside of high gasoline prices. Despite all of the subsidies and all of the hoopla over the Chevy Volt (only 1,700 units have been sold through April 2011) and the Chevy Cruse (now subject to a steering column recall that won't help repair negative quality perceptions), GM does not have much of a competitive presence in the small car market. Though GM held the largest overall U.S. market share in 2010, it had the smallest share (8.4%) of the small car market, which is where the demand will be if high gas prices persist. GM will certainly have to do better in that segment once the federally mandated average fleet fuel efficiency standard rises to 35.5 miles per gallon in 2016.

Reaping what it sowed, the administration finds itself in an unenviable position. It can entirely divest of GM in the short term at what would likely be a $10-to-$20 billion taxpayer loss (the stock price will drop if 500 million shares are put up for sale in short period) and face the ire of an increasingly cost- and budget-conscious electorate. Or the administration can hold onto the stock, hoping against hope that GM experiences economic fortunes good enough to more than compensate for the stock price-suppressing effect of the market's knowledge of an imminent massive sales, while contending with accusations of market meddling and industrial policy.

The longer the administration retains shares in GM, it will be tempted to meddle to achieve politically desirable results.

Redefining Success

Or, the administration can do what it is going to do: first, lower expectations that the taxpayer will ever recover $50 billion. Here's a recent statement by Tim Geithner: "We're going to lose money in the auto industry ... We didn't do these things to maximize return. We did them to save jobs. The biggest impact of these programs was in the millions of jobs saved." That's a safe counterfactual, since it can never be tested or proved. (There are 225,000 fewer jobs in the auto industry as of April 2011 than there were in November 2008, when the bailout process began.)

Second, the administration will argue that the Obama administration is only on the hook for $40 billion (the first $10 billion having coming from Bush). In a post-IPO, November 2010 statement revealing of a man less concerned with nation's finances than his own political prospects, President Obama asserted: "American taxpayers are now positioned to recover more than *my administration* invested in GM, and that's a good thing." (My emphasis).

Lasting Implications

The lasting implications of the bailout will depend on whether or not Americans ultimately accept the narrative that the bailout was a success. If it is considered a success, the threshold for interventions will have been lowered and Americans will have the opportunity to judge similar bailouts in the future. If it is considered a failure—as it should be—the lasting implications will be less destructive because the threshold that tempts interventionists will be higher. On that score, contrary to what the administration would have the public believe, gauging the "success" of the GM bailout requires consideration of more than just the ratio of finances recouped over financial outlays.

There are numerous other costs that don't factor into that equation.

If the bailout is considered a success, some of the likely lasting implications will include the following:

- Fear mongering will be considered an effective technique to stifle debate and enable a stampede toward the politically expedient outcome
- Americans will be more willing to extend powers without serious objection to the executive branch that we would not extend in the absence of a perceived crisis
- An increase in government interventions and bailouts of politically important entities
- Greater diversion of productive assets (resources for R&D and engineering) to political ends (lobbying and lawyering)
- A greater uncertainty to the business climate, as the rule of law is weakened and higher risk premiums are assigned to U.S. economic activity
- Riskier behavior from Ford Motor Company, knowing it has "banked" its bailout
- A greater push from the administration for a comprehensive national industrial policy
- Less aversion to subsidization of chosen industries abroad

Conclusion

The objection to the auto bailout was not that the federal government wouldn't be able to marshal adequate resources to help GM. The most serious concerns were about the consequences of that intervention — the undermining of the rule of law, the property confiscations, the politically driven decisions and the distortion of market signals.

Any verdict on the auto bailouts must take into account, among other things, the illegal diversion of TARP funds, the forced transfer of assets from shareholders and debt-holders to pensioners and their union; the willingness of the executive branch the higher-risk premiums consequently built into U.S. corporate debt; the costs of denying Ford and the other more worthy automakers the spoils of competition; the costs of insulating irresponsible actors, such as the autoworkers' union, from the outcomes of an apolitical bankruptcy proceeding; the diminution of U.S. moral authority to counsel foreign governments against market interventions; and the lingering uncertainty about policy that pervades the business environment to this day.

GM's recent profits speak only to the fact that politicians committed more than $50 billion to the task of rescuing those companies and the United Auto Workers. With debts expunged, cash infused, inefficiencies severed, ownership reconstituted, sales rebates underwritten and political

obstacles steamrolled — all in the midst of a recovery in U.S. auto demand — only the most incompetent operations could fail to make profits.

But taxpayers are still short at least $10 billion to $20 billion (depending on the price that the government's 500 million shares of GM will fetch), and there is still significant overcapacity in the auto industry.

The administration should divest as soon as possible, without regard to the stock price. Keeping the government's tentacles around a large firm in an important industry will keep the door open wider to industrial policy and will deter market-driven decision-making throughout the industry, possibly keeping the brakes on the recovery. Yes, there will be a significant loss to taxpayers. But the right lesson to learn from this chapter in history is that government interventions carry real economic costs – only some of which are readily measurable.

Appendix:
Auto Bailout-Related Articles, Op-eds, and Blog Posts by Daniel Ikenson

Articles

Hard Lessons from the Auto Bailout, *Cato Policy Report*, November/December 2009,
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Congressional Testimony

Daniel J. Ikenson
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before the
Subcommittee on Commercial and Administrative Law
Committee on Judiciary
United States House of Representatives
Ramifications of Auto Industry Bankruptcies
July 22, 2009
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2. Don't Bail Out the Big Three, *The American*, November 21, 2008, http://www.cato.org/pub_display.php?pub_id=9804
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13. Bailouts Beget More Bailout, June 16, 2011, *USA Today*, http://www.cato.org/pub_display.php?pub_id=13203

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1. http://blogs.forbes.com/beltway/2011/06/03/obama-whitewashing-the-auto-bailouts/
2. http://blogs.forbes.com/beltway/2011/05/13/obamas-gm-quagmire-2/
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4. http://blogs.forbes.com/beltway/2010/11/19/what-obamas-talk-about-gm-tells-you-about-obama/
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