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Written Testimony of Ron Bloom, Former Senior Advisor to the Secretary of the Treasury Before the House Subcommittee on Regulatory Affairs, Stimulus Oversight and Government Spending
"Lasting Implications of the General Motors Bailout"
June 22, 2011

Chairman Jordan, Ranking Member Kucinich, and members of the Subcommittee, thank you for the opportunity to testify before you today. I am here to report on the Obama Administration's investments in General Motors (GM) and Chrysler.

As you may know, since February 2011, I have served on the National Economic Council as Assistant to the President for Manufacturing Policy. While I am here in my capacity as a former Treasury official, I no longer work at Treasury and therefore no longer participate in the oversight of Treasury's automotive investments. Thus, I am not in a position to discuss events since February 2011 or anything concerning possible future actions. Further, I understand that the Committee has taken an interest in issues regarding the pensions of certain former employees of the Delphi Corporation. As I communicated in a letter to the Chairman yesterday, I am a party to a lawsuit–*Black et al. v. PBGC et al.*–that is currently pending in federal court in Michigan. I have been named as a defendant in that matter in both my official capacity as a former Treasury employee as well as in my individual capacity. I am therefore not in a position to speak to the Delphi pension issue in any way.

Background on Auto Industry Involvement

When President Obama took office, the American automobile industry was on the brink of collapse. Access to credit for car loans dried up and U.S. auto sales plunged by 40 percent. Auto manufacturers and suppliers dramatically curtailed production. In the year before President Obama took office, the industry shed over 400,000 jobs.[1] As 2008 came to a close, both GM and Chrysler were running out of cash and faced the prospect of uncontrolled liquidations. Amid the worst financial crisis since the Great Depression, credit markets were frozen and no alternative sources of financing were available to GM and Chrysler. In this context, the potential collapse of the U.S. auto industry posed a substantial risk to financial market stability and would have had a negative effect on the economy as a whole. Therefore, the previous Administration provided $24.8 billion to the auto industry.[2].

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[1] http://www.bls.gov/iag/tgs/iagauto.htm. Automotive Industry: Employment, Earnings, and Hours. Bureau of Labor Statistics.

[2] The previous Administration provided $13.4 billion to GM, $4.0 billion to Chrysler, $5.9 billion to Ally Financial (formerly GMAC), and $1.5 billion to Chrysler Financial.

When President Obama took office, we faced a full-fledged recession, our financial system was still exceedingly fragile, and GM and Chrysler were requesting additional assistance. After studying the restructuring plans submitted by GM and Chrysler, President Obama decided that he would not commit any additional taxpayer resources to these companies without fundamental change and accountability. He rejected their initial plans and demanded that they develop more ambitious strategies to reduce costs and increase efficiencies to become more sustainable.

However, President Obama also recognized that failing to stand behind these companies would have consequences that extended far beyond their factories and workers. GM and Chrysler were supported by a vast network of auto suppliers, which employed three times as many workers and depended on the automakers' business to survive. An uncontrolled liquidation of a major automaker would have had a cascading impact throughout the supply chain, causing failures and job loss on a much larger scale. Because Ford and other auto companies depended on those same suppliers, the failure of the suppliers could have caused those auto companies to fail as well.[3] Also at risk were the thousands of auto dealers across the country, as well as small businesses in communities with concentrations of auto workers.

It was the interdependence among the automakers, suppliers, dealers, and communities that led some experts at the time to estimate that at least 1 million jobs could have been lost if GM and Chrysler went under.[4] Other estimates suggested that job losses could have been even higher.[5]

These were grave risks at a time when our economy was losing 750,000 jobs per month and our financial system was still at risk. Credit markets were still not functioning properly and bank lending had contracted substantially, and therefore there was no chance of securing private lending on a scale sufficient to save GM and Chrysler. To avoid the liquidation of the companies, the President decided to give GM and Chrysler a chance to show that they could take tough and painful steps to become viable, profitable companies—and to stand behind them if they could. Working with their stakeholders and the President's Auto Task Force, both GM and Chrysler underwent fair and open bankruptcies that resulted in stronger global companies. This process required deep and painful sacrifices from all stakeholders—including workers, retirees, suppliers, dealers, creditors, and the countless communities that rely on a vibrant American auto

[3] http://voices.washingtonpost.com/economy-watch/2008/12/fords_mulally_gm_would_drag_en.html. "Ford's Mulally: GM Would Drag Entire Industry Into Bankruptcy." *The Washington Post*. December 3, 2008.

[4] http://www.cargroup.org/documents/Detroit_Three_Contraction_Impact.pdf. "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers." Center for Automotive Research. November 4, 2008.

[5] http://banking.senate.gov/public/_files/ZandiSenateBankingCommittee120408.pdf. Mark Zandi, "The State of the Domestic Auto Industry: Part II." Testimony before the U.S. Senate Banking Committee. December 4, 2008.

http://www.epi.org/page/-/pdf/bp227.pdf?nocdn=1. Robert E. Scott, "When giants fall: Shutdown of one or more U.S. carmakers could eliminate up to 3.3 million U.S. jobs." Economic Policy Institute. December 3, 2008.

industry. However, the steps that the President took not only avoided a catastrophic collapse and brought needed stability to the entire auto industry, they also kept hundreds of thousands of Americans working and gave GM and Chrysler a chance to once again become viable, competitive American businesses. And they avoided further shocks to our financial system and economy at a time when we could least afford it.

Auto Industry Recovery

Today, the American auto industry is mounting a comeback. In the first quarter of 2011, the industry reached an important milestone when all three Detroit automakers returned to profitability for the first time since 2004. Chrysler achieved its first quarter of positive net income since emerging from bankruptcy. GM’s first quarter 2011 profit was nearly triple its profit from the same quarter last year and was the company’s fifth consecutive quarterly profit. Ford’s first quarter 2011 net income marked its best first-quarter performance since 1998 and the company's eighth consecutive quarterly profit.

This positive financial performance is the result of expanded production and sales. In 2010, GM, Chrysler, and Ford increased their market share from 41.0 percent to 44.4 percent. The last time the Detroit three gained market share against their foreign competitors was in 1995. In addition, exports of vehicles and parts in 2010 increased by 37 percent over 2009. Sales to China are doing particularly well. Exports of vehicles and parts to China were up 137 percent in 2010, totaling $4.5 billion.[6]

This increase in market share and exports translates into more American jobs. Since June 2009, the auto industry has added 113,000 jobs—the fastest pace of job growth in the auto industry since 1998.[7] In addition, since June 2009, GM and Chrysler have announced investments totaling over $8 billion in their U.S. facilities, creating or saving nearly 20,000 jobs. GM recently announced that it would invest an additional $2 billion in U.S. factories in the coming months, creating or preserving more than 4,000 jobs at 17 facilities in eight states.

Investments and Repayments

The U.S. Government provided a total of $80 billion to stabilize the U.S. automotive industry through investments in GM, Chrysler, Chrysler Financial, Ally Financial (formerly GMAC), and programs to support auto suppliers and guarantee warranties. As of today, $40 billion has been returned to taxpayers. While the Government does not anticipate recovering all of the funds that it invested in the industry, loss estimates from Treasury and the Congressional Budget Office

[6] http://tse.export.gov/TSE/. TradeStats Express. Department of Commerce.

[7] http://www.bls.gov/iag/tgs/iagauto.htm. Automotive Industry: Employment, Earnings, and Hours. Bureau of Labor Statistics.

have consistently improved. Independent analysts estimate that the Administration's intervention saved the federal government tens of billions of dollars in direct and indirect costs, including transfer payments like unemployment insurance, foregone tax receipts, and costs to state and local governments.[8]

Treasury committed $12.5 billion to Chrysler ($4.0 billion under the Bush Administration and $8.5 billion under the Obama Administration, including undrawn commitments of $2.1 billion). In May 2011, Chrysler repaid $5.1 billion in loans six years before their maturity date and terminated its ability to draw on the remaining $2.1 billion commitment. In June 2011, Fiat agreed to pay Treasury $500 million for its equity in Chrysler.[9] Following the closing of this sale to Fiat and all previous repayments, Treasury will have recouped $11.2 billion.

Treasury provided $49.5 billion to GM ($13.4 billion under the Bush Administration and $36.1 billion under the Obama Administration), of which $23.2 billion has been returned to taxpayers. In April 2010, GM repaid its $6.7 billion loan to Treasury five years before its maturity date. In November 2010, Treasury sold 45 percent of its GM common equity for $13.5 billion in net proceeds from a highly successful initial public offering (IPO). In December 2010, GM repurchased all $2.1 billion of Treasury's preferred stock. Treasury currently holds 500.1 million shares or 32 percent of GM's common equity. Following GM's IPO, Treasury has a clear path to exit its remaining investment. The government remains a reluctant shareholder and intends to dispose of its investment as soon as practicable, with the dual goals of achieving financial stability and maximizing returns to taxpayers.

Conclusion

In a better world, the choice to intervene in GM and Chrysler would not have had to be made. But amid the worst economic crisis in a generation, the Administration's decisions avoided devastating liquidations and provided the American auto industry a new lease on life and a real chance to succeed.

Thank you again for the opportunity to testify. I look forward to your questions.

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[8] http://www.cargroup.org/pdfs/prnov2010.pdf and http://www.cargroup.org/pdfs/bankruptcy.pdf. "The Impact on the U.S. Economy of the Successful Automaker Bankruptcies." Center for Automotive Research. November 17, 2010.

[9] Fiat also agreed to pay Treasury $60 million for its right to proceeds above a certain threshold received by the United Auto Workers retiree healthcare trust (or VEBA). http://www.treasury.gov/press-center/press-releases/Pages/tg1199.aspx

Testimony
of
Vincent K. Snowbarger, Deputy Director for Operations
Pension Benefit Guaranty Corporation
before the
Subcommittee on Regulatory Affairs, Stimulus Oversight and Government Spending
Committee on Oversight and Government Reform
U.S. House of Representatives

June 22, 2011

Good afternoon Chairman Jordan, Ranking Member Kucinich and other Subcommittee Members. I am Vince Snowbarger, Deputy Director for Operations of the Pension Benefit Guaranty Corporation ("PBGC" or "the Corporation").

The most visible part of PBGC's work occurs when it steps in to terminate and become trustee of failed defined benefit ("DB") pension plans. First, however, PBGC tries to preserve plans and keep pension promises in the hands of the employers who make them. During FY 2010, PBGC helped 38 companies in bankruptcy keep their plans, enabling about 250,000 workers and retirees keep their full pension benefits. Every plan retained by its sponsor is a victory both for the plan's participants and for PBGC.

As part of this hearing on "Lasting Implications of the General Motors Bailout," I will testify today about the DB pension plans sponsored by companies in the automotive and auto supply industries. I will also discuss the impact the restructuring in these industries has had on the DB pension system and on the PBGC's pension insurance program.

In particular, I will describe the impact of the restructuring on the underfunded pension plans of Delphi Corporation, the nation's largest producer of auto parts. I will also describe the developments that forced us to step in to protect the pensions of Delphi's 70,000 workers and retirees. We are now responsible for about $6 billion of the plans' shortfall, but about $1.2 billion of benefits is not guaranteed by the insurance program.

<u>PBGC</u>

The need for a federal pension safety net became starkly evident when, at the end of 1963, the Studebaker Corporation, then the nation's oldest major automobile manufacturer, closed its U.S. operations and terminated its DB pension plan. About 4,000 workers lost the bulk of their pensions, receiving only fifteen cents on the dollar of vested benefits. At an average age of 52, these Studebaker employees had worked for the company an average of 23 years.

In 1974, Congress passed the Employee Retirement Income Security Act ("ERISA") which, among other protections, created PBGC to insure pensions earned by American workers under private-sector DB plans. We now insure the pensions of more than 44 million workers, retirees, and beneficiaries in about 30,000 DB plans. When a plan terminates in an underfunded condition – usually because the employer responsible for the plan goes out of business or can no longer fund the promised benefits – PBGC takes over the plan as trustee and pays benefits to the full extent permitted by law.

What PBGC Does

In the aftermath of the economic crisis, PBGC responded to the wave of corporate bankruptcies by stepping up its work to protect plans. Our staff negotiated with dozens of companies, in bankruptcy, through our Early Warning Program and when corporate downsizing events occurred, to preserve their DB plans.

Under the Early Warning Program, PBGC monitored more than 1,000 companies to identify transactions that could threaten a company's ability to pay pensions, and negotiated protections for the plans. We can also step in and negotiate protection for the pension plan, including a guarantee, posting collateral or additional contributions to the plan when major layoffs due to plant closures occur. In this way, last year PBGC secured an additional $250 million in protections for participants in about 20 pension plans.

When companies do enter bankruptcy, we encourage them to keep their plans ongoing. In large bankruptcy cases, the stakes for workers and retirees and the pension insurance program can be tremendous. If a company can exit bankruptcy with its pension plans ongoing, PBGC can avoid taking on substantial liabilities. If the company sheds its plan, PBGC can be saddled with the addition of billions of dollars to its deficit. Unfunded benefits can also mean benefit losses to those workers, retirees, and beneficiaries whose benefits exceed the amounts guaranteed by law.

During FY 2010, the agency worked with debtors and creditors to help 38 companies who were reorganizing in bankruptcy keep their plans. As a result, approximately 250,000 workers and retirees continue to enjoy their full pension benefits, while continuing to be protected by PBGC insurance coverage. This is almost 2½ times the number of participants in plans that failed.

Despite PBGC's efforts to preserve pensions, 147 underfunded single-employer plans did terminate in FY 2010, most often in bankruptcy, and PBGC took up responsibility for an additional 109,000 workers, retirees, and beneficiaries.

For the past 36 years, PBGC has stepped in to pay benefits – on time, every month, without interruption. These benefit payments are important, often crucial, to the retirement income security of retirees and workers in trusteed plans, many of whom worked decades for their promised benefits. In FY 2010, PBGC paid nearly $5.6 billion in benefits to about 801,000 retirees and beneficiaries in 4,200 failed plans; another 669,000 participants will receive benefits in the future. Since the beginning of FY 2011, PBGC has become responsible for current and future benefit payments for another 30,000 individuals.

Governance and Structure

PBGC is a wholly-owned federal government corporation overseen by a three-member Board of Directors consisting of the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury. The Corporation is administered by a presidentially-appointed, Senate-confirmed Director. The Corporation also has a seven-member Advisory Committee appointed by the President to represent the interests of labor, employers, and the general public.

PBGC operates two pension-insurance programs, which are financially separate. The single-employer program covers about 34 million workers, retirees, and beneficiaries in about 26,000 single-employer plans. The smaller multiemployer program – which covers collectively bargained plans that are maintained by two or more unrelated employers – protects more than 10 million workers, retirees, and beneficiaries in about 1,500 multiemployer plans.

Although PBGC is a federal government corporation, it receives no funds from general tax revenues and by law its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets received from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for underfunded trusteed plans.

AUTO INDUSTRY

In 2009, as GM and Chrysler requested government assistance, President Obama established the Presidential Task Force on the Auto Industry (Auto Task Force) to evaluate the companies' restructuring plans. The Auto Task Force consulted PBGC to determine the scope of pension underfunding in the automotive and auto supply industries.

As part of the Troubled Asset Relief Program, Treasury provided funding to help GM and Chrysler fund their operations while they restructured. To implement the restructuring plans, both companies filed for bankruptcy reorganization. When New GM and New Chrysler emerged in 2009, they assumed sponsorship of all the old companies' DB plans. As a result, more than 700,000 participants in the GM plans and more than 250,000 participants in the Chrysler plans kept their full plan benefits.

U.S. automakers sponsor some of the largest private sector DB plans, and many auto suppliers also sponsor DB plans insured by PBGC. Even before the GM and Chrysler bankruptcies, DB plans sponsored by auto suppliers were significantly underfunded. We closely monitor troubled companies with underfunded plans and, where possible, negotiate to obtain plan protections.

PBGC has worked on behalf of DB plan participants and the pension insurance program as an unsecured creditor in numerous bankruptcy cases, and as a contingent unsecured creditor in the GM and Chrysler bankruptcies. In 2007, when Daimler AG sold its interest in Chrysler to Cerberus, PBGC obtained a $1 billion guarantee for the pension plans from Daimler and an additional $200 million contribution from Chrysler. In conjunction with Chrysler's reorganization in 2009, we renegotiated Daimler's $1 billion guarantee and obtained $600 million in contributions for the Chrysler pension plans and a $200 million guarantee from Daimler. The bankruptcy court approved the agreement, Daimler made the contributions, and the $200 million guarantee remains in effect.

Since 2004, about 50 auto suppliers with DB plans have filed for bankruptcy protection. PBGC terminated and trusteed the plans of about half of those auto suppliers. During the same period, however, about half of those auto suppliers emerged from bankruptcy with their pension plans ongoing. For example, in 2009, we reached an agreement with Visteon Corp. to provide additional protection for their pension plan covering more than 5,300 former employees of the automotive supplier. Visteon ultimately agreed to accelerate a $10.5 million cash contribution to the plan, provide a $15 million letter of credit, and provide for a guaranty by certain affiliates of certain contingent pension obligations of up to $30 million. Separately, in 2010, Visteon was able to emerge from bankruptcy as a stronger company with its pension plans ongoing.

DELPHI CORPORATION

Delphi, which was originally created as an in-house parts manufacturer for GM, was spun off as an independent company in 1999. At that time, GM transferred assets and liabilities from its salaried and hourly pension plans to the newly established Delphi Salaried and Hourly DB pension plans. GM negotiated with certain unions to provide benefit guarantees if the Delphi Hourly plan terminated or was frozen at a later date.

Delphi's Bankruptcy

Delphi was one of about 50 auto suppliers that we were monitoring under our Early Warning Program. After the spinoff in 1999, PBGC actively monitored Delphi, focusing on its credit profile and corporate transactions that could have put the pension plans at risk. While Delphi suffered large losses between 2001 and 2005, the company maintained its investment grade credit ratings until early 2005 when it was downgraded to speculative grade. At that time (approximately five months before bankruptcy), Delphi refinanced a large portion of its debt. PBGC engaged with Delphi management on the refinancing transaction. Delphi contributed some of the proceeds from that transaction to its pension plans.

After Delphi entered bankruptcy protection in October 2005, PBGC worked intensively with Delphi, GM, and other stakeholders to keep the pension plans ongoing. During the bankruptcy, Delphi consistently told PBGC and its employees that it intended to reorganize with its pension plans ongoing. However, Delphi failed to make required minimum funding contributions to the plans and, as a result, liens were triggered on behalf of the plans against the assets of Delphi's non-bankrupt foreign subsidiaries. Beginning in March 2006, PBGC perfected these liens as the law provided, so that the plans had a secured interest against the foreign Delphi entities.

In September 2007, Delphi filed a reorganization plan with the bankruptcy court. As part of the reorganization, GM and Delphi entered into a settlement agreement to transfer part of

Delphi’s Hourly plan to GM’s Hourly plan. Under the reorganization plan, Delphi was to continue to sponsor all its other pension plans, including the Salaried plan. Delphi did not plan to transfer any pension liability to PBGC.

In April 2008, Delphi’s reorganization deal fell through, and the next month, previously granted IRS pension funding waivers expired. As collateral for the waivers, Delphi had obtained bankruptcy court approval to provide PBGC with $172.5 million in the form of letters of credit. In order to protect the plans, PBGC drew down on the Delphi letters of credit, which resulted in $122.5 million in contributions to the Hourly plan and $50 million to the Salaried plan.

In the latter half of 2008, Delphi still anticipated that it could reorganize in bankruptcy, maintain its Salaried plan, and merge the Hourly plan into the GM Hourly plan. In September 2008, Delphi and GM, with the approval of the bankruptcy court, amended their settlement agreement to provide for a transfer of up to $3.4 billion of net liabilities from Delphi’s Hourly plan to GM’s Hourly plan in two phases. The first $2.1 billion was transferred the same month. This provided added security for retirees and employees of Delphi, and also reduced PBGC’s exposure to loss. Between September and November 2008, Delphi froze benefit accruals in the Hourly and Salaried pension plans.

The second transfer of liabilities to GM was to be made upon Delphi’s emergence from bankruptcy. Unfortunately, the severe downturn in the auto markets made it impossible for Delphi to afford the Salaried plan or to pay to GM the consideration previously promised for transfer of the remaining portion of the Hourly plan to GM.

Recoveries and Benefit Payments

Delphi’s proposed modifications to its plan of reorganization, approved by the bankruptcy court in late July 2009, called for the liquidation of Delphi, the sale of its remaining valuable assets, and termination of the Delphi plans; and the modifications included provisions for settlement of PBGC’s claims. The settlement included in Delphi’s modified plan of liquidation provided PBGC with a $3 billion general unsecured claim against Delphi’s bankruptcy estate. In addition, the investors in the new company that had agreed to purchase Delphi’s foreign subsidiaries, which included New GM, required PBGC to release its liens and claims on those foreign assets before the purchase could proceed. At the time of the settlement, PBGC had a $196 million lien on behalf of the Salaried plan. The September 2008 transfer of Hourly plan liabilities to GM eliminated PBGC’s lien on behalf of the Hourly plan.

In exchange for the release of the Salaried plan lien and PBGC’s other claims, PBGC reached an agreement with the buyers that provided PBGC with a $70 million cash payment from GM and a membership interest in the new company, which had been created as a U.K. partnership. PBGC’s membership interest provided that PBGC would receive approximately ten percent of the first $7.2 billion of distributions that the new Delphi partnership made to its members. The cash payment and membership interest effectively paid PBGC’s Salaried plan lien and, in the context of Delphi’s bankruptcy gave PBGC a reasonable recovery on its other claims; therefore, PBGC released its claims against, and statutory liens on, Delphi’s foreign subsidiaries. In March of 2011, new Delphi redeemed PBGC's stake in the company for $594 million.

The law provides a formula for PBGC to allocate a portion of its total recoveries to provide benefits that are not guaranteed or funded by plan assets. Generally, the Delphi recoveries may allow PBGC to pay additional benefits to older Delphi workers who retired or could have retired by July 31, 2006, three years before the Delphi plans terminated, and who are now receiving benefits less than those promised to them by Delphi due to the statutory limits on the amount that PBGC can pay. However, because the amount of PBGC's recovery is less than 10 percent of the benefits that Delphi promised but failed to fund, any benefit increases are likely to be small.

Since PBGC became trustee of the Delphi plans in August 2009, we have been making uninterrupted payments to retirees and putting new retirees into pay status as they apply. Participants receive estimated payments until calculations are final. Calculating benefits for the 70,000 workers and retirees in the six Delphi plans poses challenges because of complex benefit structures and mergers and acquisitions that took place throughout the life of the plans. It will take several years to fully review Delphi's plans, verify participant information, and determine benefit amounts. We plan to issue most final benefit determinations in 2013. A group of Delphi Salaried plan participants has sued PBGC and the Treasury Department seeking to undo the plan termination. The litigation is ongoing.

CONCLUSION

This is a time of great challenge for all of us in the public sector who are trying to assure American working families of financial security in retirement. In one sense we've been fortunate. Despite the greatest financial turmoil in many decades, fewer plans were terminated than many observers had expected.

In part, this also may be due to PBGC's own efforts. We continued to respond to the recent wave of corporate bankruptcies by stepping up and stepping in. We worked tirelessly to convince companies, both in and out of bankruptcy, to preserve their plans. In many instances, this approach worked. However, underfunding in plans sponsored by financially weak companies remains high, and PBGC's effort to preserve pensions can only succeed where the plan sponsor's business survives and is large enough to support the pensions. In the unfortunate cases like Delphi, where the sponsor failed and liquidated and the remaining business was a fraction of the size of the unfunded pension liabilities, PBGC is forced to, and will, step in to protect the pensioners from the fate suffered by the Studebaker retirees some fifty years ago.

In sum, companies that sponsor pension plans have a responsibility to live up to the promises they made to their workers and retirees. But when a company cannot keep its promises, PBGC provides a dependable safety net for workers and retirees.

I would be happy to answer any questions.

STATEMENT of Daniel J. Ikenson
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before the

Subcommittee on Regulatory Affairs, Stimulus Oversight and Government Spending
Committee on Oversight and Government Reform
United States House of Representatives

Lasting Implications of the General Motors Bailout

June 22, 2011

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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Daniel J. Ikenson
Associate Director, Center for Trade Policy Studies,
Cato Institute, Washington, DC
before the
Subcommittee on Commercial and Administrative Law
Committee on Judiciary
United States House of Representatives
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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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Thomas A. Kochan
Testimony before the Committee on Oversight and Government Reform
on
"Lasting Implications of the General Motors Bailout"

Thomas A. Kochan[1]
June 22, 2011

Mr. Chairman and members of the Committee, thank you for the opportunity to testify today. I wish to make three points in this testimony:

1. Government actions to restructure General Motors (GM) and Chrysler through controlled bankruptcy processes were essential to and successful in saving between 1 and 3 million jobs, avoiding a potential second Great Depression, and providing the pressure and the opportunity for U.S. firms to reemerge as world class competitors in the global auto industry.

2. Support of the UAW and other unions with on-going relationships with GM during this restructuring process was critical to the survival of these companies and the entire U.S. auto industry. Further support and cooperation between the company and the union are essential for GM (and other auto industry companies) for building sustainable jobs and enterprises in the future.

3. The specific "top-up" provisions governing Delphi hourly employees were negotiated as part of a complex-multi-issue, multi-party agreement governing the creation of Delphi in 1999 and again in the restructuring negotiations during the Delphi bankruptcy proceedings in 2006. To retrospectively single out and renege on this provision during the 2008-09 restructuring and bankruptcy processes would have materially harmed the on-going union management relationship and jeopardized the industry's restructuring and rebuilding process.

Government Actions in the Restructuring Process

The combined actions of the Bush and Obama Administrations to support the restructuring of the U.S. auto industry in 2008 and 2009 will likely be assessed by historians as

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one of the most important and effective steps taken during that perilous time to avoid the Great Recession from descending into a second Great Depression. These actions saved somewhere between 1 and 3 million jobs in 2009 and perhaps more in subsequent years.[2] They also avoided setting off a cascading set of costs and revenue losses to state, federal, and local government budgets that would have resulted from the increased unemployment insurance costs of between $8 billion and $25 billion, losses in GDP that would in turn reduce revenues to state governments between $15 and $48 billion, and reduced federal revenues between $59 and $177 billion.[3] The combined effects of the loans of $12.5 Billion to Chrysler and approximately $50 billion to GM, structural adjustments and additional concessions from workers and creditors, leadership changes, and in the case of Chrysler, the joint venture with Fiat, have positioned the U.S. auto industry to reemerge as a world class competitor. For the first time in over a decade General Motors, Chrysler, and Ford each reported profitable quarters in 2011, each is expanding capacity and hiring workers, and collectively these U.S. firms are gaining market share in the domestic and global industry.

I emphasize the effects of these actions on the entire U.S. auto *industry* because of the high degree of interdependence that exists across auto assemblers, suppliers, and dealers. The effects of the largest firm (GM) entering a bankruptcy without a "debtor-in-possession" financing option would have produced at best a long and uncertain restructuring process and at worst potential liquidation of the company. Either outcome would have set off a chain reaction that would likely have brought down a significant portion of auto industry suppliers, and significantly harmed other assembly firms and multiple dealers in communities across the country.

Indeed, the interdependence across the major assemblers and suppliers has grown over the years as more components have been outsourced, in some cases to single source suppliers. In 1980, for example, the ratio of jobs in independent parts' suppliers to the major assembly firms was 1.2 to 1; in 2008 it had grown to 3.5 to 1.[4] Moreover, most supplier firms provide components to multiple assemblers. Delphi, for example, is the sole source supplier of

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[2] These estimates are for jobs likely to be lost in 2009 under different scenarios, depending on the extent of direct and indirect job loss that would cascade throughout the industry. They are consensus estimates from three independent sources: The Employment Policy Institute, the Center for Automotive Research, and the White House. For the specific sources see Robert E. Scott, "Huge Return on Taxpayer Investment," Employment Policy Institute Issue Brief 209, November 18, 2010, p. 2, Table 1.

[3]See Table 2 and Table 3 of the above report for these estimates from the same three sources.

[4] Susan Helper, "The U.S. Auto Supply Chain: After the Crisis," Presentation to the Global Economics Roundtable, April 8, 2011. Available from the author at Case Western Reserve University.

"cockpits" (a module of parts that include most of what appears on the "dashboard" of a vehicle) to the Mercedes plant in Alabama. If Delphi had been forced into liquidation, Mercedes production would have been shut down. This is only one of many examples of how the cascading effects an uncontrolled or extended bankruptcy of GM would have affected Delphi and other supplier and assembly firms.

Ford, in particular, would have been put at risk by an extended and uncertain outcome of a GM bankruptcy since it outsources an even higher proportion (over half) of its components to outside suppliers than does GM or Chrysler.[5] Instead, Ford not only avoided bankruptcy, it used the time gained in the past several years to build a strong partnership with the UAW that will serve as a model for others in the industry in the years ahead.

Importance of UAW Support

The survival of GM and Chrysler through these processes required the support of the UAW and other key unions with on-going relationships with these companies. Moreover, for these companies to continue to prosper and build sustainable jobs and enterprises, labor management relations will need to continue the transformation process that began prior to the crisis. The transformation process involved both deep economic concessions by the workforce and joint union-management effort to improve the quality of their relationships on the shop floor, in negotiations, and in consultative and information sharing processes at the highest levels of the companies and unions. In 2007 negotiations Ford, GM, and Chrysler and the UAW agreed to restructure and lower the costs of health care and pensions for current and retired employees and cut wages and starting salaries to levels that matched or approached those of their major competitors. Each of the companies had also been working to build knowledge based work systems that engage workers and unions in fostering innovation, productivity and quality improvements. Years of research evidence and experience had demonstrated to the companies and the union that they needed to work together as partners in leading and sustaining this transformation process.[6]

Top-up Provision History and Context

[5] See comments of Ford CEO Alan Mulally, "The Daily Beast Talks with Ford's CEO," *The Daily Beast*, October 16, 2010.

[6] For a summary of this research and the varying degrees of progress made in this transformation process see Susan Helper, John Paul MacDuffie, Joel Cutcher-Gershenfeld, Teresa Ghilarducci, and Thomas Kochan, "Best Options for the Auto Industry Crisis," November 20, 2008. Available from this author on request.

The UAW negotiated the provisions to protect its members' pensions in 1999 when Delphi was initially severed off as a separate company from GM. At that point the union recognized there was a significant risk that Delphi might not survive and, therefore, as a responsible union, it negotiated a number of contingency provisions to protect its members' and retirees' benefits. These negotiations, and subsequent negotiations that took place when Delphi was indeed forced to declare bankruptcy in 2006, involved multiple issues and resulted in tradeoffs and economic concessions/sacrifices by all of the stakeholders—current workers, future workers, retirees, creditors, GM, and Delphi. To single out one provision, the so called pension "top-up" clause, for scrutiny at this late date without considering the overall package of tradeoffs and concessions negotiated prior to or during the restructuring processes would be highly inappropriate and counterproductive. Moreover, there is a well-established principle (the contract assumption provision in Section 365 of the Bankruptcy Code) of honoring prior contracts of suppliers or other stakeholders with critical on-going relationships with a company. This is exactly the case here.

Looking to the Future

Several decades of research has shown that world class performance in the auto industry (and others) requires employment relationships characterized by high trust, teamwork, and worker engagement; negotiations that focus on critical interests and problems, and; on-going information sharing, consultation, and partnership among union and management leaders. [7] This has been a struggle to achieve in the U.S. auto industry. GM, Chrysler, and Ford were making varying degrees of progress on these fronts in the years prior to the collapse of the financial system and the freezing of credit markets that resulted in the dramatic drop in auto sales. The government actions to provide loans and debt financing and to help orchestrate orderly and swift bankruptcy restructuring processes for GM and Chrysler saved the industry from entering an interdependent free fall and has given the industry the opportunity to get back on the task of transforming their labor and employee relations in ways needed to meet world class standards. This could not have been accomplished without the active and on-going engagement of the unions representing U.S. autoworkers. These same parties now need to focus on their future challenges and opportunities. I believe they are well positioned and prepared to do so.

I would be pleased to answer any questions you might have.

[7] See Helper et.al. For a broader review of this evidence see Eileen Appelbaum, Jody Hoffer Gittell, and Carrie Leona, "High Performance Work Practices and Sustainable Economic Recovery," available at www.employmentpolicy.org.

Reason

Testimony of Shikha Dalmia
Senior Analyst

Reason Foundation

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.

<u>The Bailout Has Legitimized Increased Government Management of Private Companies</u>

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.