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On the Issues

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Corporate Taxes Are Killing the U.S. Auto Industry

By Kevin A. Hassett

Sustained losses in the U.S. auto industry have raised questions in recent weeks about the likelihood of a government bailout. The auto industry's failure to keep up with competition and adjust to new market demands is worsened by a tax structure that discourages production. In order to revive the floundering auto industry, we should lower the corporate tax structure to a competitive level, rather than pour government money into an anemic industry.

Suppose you worked hard and invented a better product, and it was so successful that you registered sales of $171 billion over the past twelve months. How much would your company be worth?

You might feel like you had made it to easy street. After all, General Electric had revenue of $180 billion over the past year, and the total market value of the firm was a whopping $295 billion as of August 8. Or maybe you could even do better than that. Cisco Systems had revenue of $39.5 billion, and it was worth $143 billion as of last week.

But before you make your guess, let me add this condition: your product is an automobile. In terms of market value, that condition is about as negative as it can get. In football, it is like learning your running back has blown out both his knees.

General Motors posted $171 billion in revenue over the past year—and its market capitalization as of August 8 was a woeful $5.7 billion. Similarly, Ford posted revenue of $163 billion over the same period and had a market capitalization of just $11 billion. To put this in perspective, General Motors is now worth a little more than half as much as motorcycle manufacturer Harley-Davidson.

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The fact is, while automakers have enormous sales, they post losses rather than profits. The companies are worth so little because investors want to own profitable businesses.

As of late, the losses have been frightful. General Motors posted a $15.5 billion loss last quarter and is hemorrhaging money at the rate of about a billion dollars a month. The automaker has roughly $20 billion on hand, and some analysts have begun to question whether it will survive.

Some Washington insiders are even dusting off their auto-bailout playbooks. Before legislative action gets going, however, the government needs to consider the sad economics of auto manufacturing. The rationale for any bailout is that short-term fluctuations have put a company in a situation from which it does not have the liquidity to escape, but the long-run prospects are rosy enough that it should not shut down.

The popular version of the auto story seems to fit this description. The surge in oil prices has hammered U.S. companies that disproportionately bet their profits on sport utility vehicles (SUVs) and trucks. Losses are high now, but profits from SUVs were significant in the past. As consumers shift toward more fuel-efficient cars, automakers

will suffer while they adjust production, but eventually they will become profitable again.

This version of the story is inconsistent with the facts. Even in the glory years of SUV profits, U.S. automakers did not make much money, if any. The firms have struggled to survive, yet they have little to show investors they can provide reasonable returns in the long run. During the past five years, Ford's tax bill was on average negative, meaning its losses were so large that the company was refunded taxes paid in previous years.

U.S. companies have a hard time turning profits for a number of reasons. The U.S. product has generally been viewed by consumers as less desirable than foreign imports. Ford and Chevrolet products have regularly received lower-quality scores from J.D. Power and Associates than Honda and Toyota products. And their less-desirable product is manufactured by an extremely costly unionized workforce.

To make matters worse, the main competitors that are not Japanese all operate out of countries with much lower tax rates than the United States. When profits pile up in the good years, U.S. companies pay about 34 percent more in taxes than those operating elsewhere in the Organisation for Economic Co-operation and Development—an international group of the richest nations. This drains cash reserves that are necessary for retooling when the bad times hit.

U.S. vehicles have suffered from lower quality for a number of reasons, including both the failure of management and labor. But the bottom line is that any company that produces a more costly, lower-quality product than the competition will have trouble turning a profit. A manufacturer can price the profit out of its product in the short run to stay afloat, but long-term prosperity is not an achievable objective absent fundamental change.

With combined sales over the past twelve months of about $330 billion, Ford and General Motors would provide an enterprising management with a golden opportunity to create a profitable business with a market capitalization that is closer to General Electric's.

If the United States stays a high-tax environment, then it may well be that investors decide it is just not profitable to base an auto manufacturer here.

But doing so would require both a radical improvement in product quality and a sharp rationalization of the production process. That is the kind of charge that an eager acquirer might be willing to take on—especially if the United States had a corporate tax that made U.S. production more desirable.

If the United States stays a high-tax environment, then it may well be that investors decide it is just not profitable to base an auto manufacturer here. Only a government-supported industry would be sustainable.

Accordingly, it seems that two distinct paths await the auto industry: Down one, the United States has a lower corporate-tax rate and a large, successful auto industry. Down the other, the government pours money into a failing industry that gets worse and worse with each passing year.

Also by Kevin A. Hassett:

Article on Bloomberg.com

"Highways to Hell" Should Go on Auction Block

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When the work day ended on July 31, the Hassett family loaded into the minivan and headed to New England for a short break. The trip presented the kind of travel nightmare that has become all too common on America's "highways to hell" and offered a glimpse of what awaits you if you are heading onto the roads for your summer break.

The fun began with construction delays north of Baltimore. Then came traffic stoppage related to an accident; congestion on the New Jersey Turnpike at the toll booths; and then the mother of all delays on Interstate 84 in Connecticut, where highway-construction workers created a forty-five-minute delay when they took the road down from three lanes to one. . . .

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