



The Auto Industry's Future

Democrats in Congress have asked the "Big Three" domestic automakers to provide a plan by early December that would return the auto industry to profitability. AEI scholars have been examining the industry's options. Martin Feldstein, a member of AEI's Council of Academic Advisers, argues that the appropriate solution for the Big Three is to file for bankruptcy. Kevin A. Hassett says that bankruptcy is not a death sentence, but rather "intensive care." Robert W. Hahn and Peter Passell share the sentiment that a bailout would be ill-advised. They suggest provocatively that we should stimulate auto buyers by offering "eye-popping" rebates for a limited time to help put the auto companies on the right road. Kenneth P. Green discusses the environmental movement's unhelpful role in efforts to return profitability to the auto industry.

A Chapter for Detroit to Open

By Martin Feldstein

The Big Three U.S. automakers need more than an injection of \$25 billion from the federal government. Because of their ongoing losses, they would burn through that money in less than a year and would soon be back for more.

General Motors (GM), Ford, and Chrysler can make excellent cars, but they cannot sell them at prices that are competitive with the prices of cars produced in the United States by Toyota and others, or with the prices of cars imported from Europe and Asia. The basic reason is the labor costs imposed by union contracts.

The Big Three pay much higher wages to their workers than others are paid in the nonunion auto firms and in the general economy. And the health care costs of current workers and retired union members are an enormous additional burden.

The simplest solution is to allow GM and the others to file for bankruptcy. If the companies file under Chapter 11, they would be able to continue producing cars, and the workforce would remain employed while the firms reorganized. The firms would also be able to get short-term credit under bankruptcy protection.

The bankruptcy court could require the unions to rewrite contracts, bringing wages down to levels that would allow the firms to compete and, therefore, to maintain employment. Scaling back employee and retiree health benefits would further improve price competitiveness and allow better cash wages. The firms' bondholders and other creditors would have to take losses. Shareholders' fate would depend on how firms responded to this restructuring.

Restructuring in bankruptcy and resetting wages are measures that have saved airlines as well as manufacturers. The claim that bankruptcy would mean the loss of millions of jobs is nonsense, intended to scare the public and force legislators and the Bush administration to throw money at the auto industry's problems.

Only by reducing wages and benefits will the firms be able to survive and provide good jobs. If politicians in Washington cannot live with the thought of the auto industry in bankruptcy and decide that some cash must be delivered, it should be done as part of a fundamental restructuring plan imposed by the government in exchange for those funds.

The goal of that restructuring should not just be to require the companies to make cars that are fuel efficient and more environmentally sound, as president-elect Barack Obama has said, although that can be included in the government's list of requirements. The goal should be to put the companies on a course that will allow them to survive for the long term, producing cars and creating jobs.

To do that, the government should insist that the unions accept reductions in wages and benefits to levels that allow the firms to compete with imports and with nonunion U.S. auto firms. The trustees of retiree benefits should be required to accept reductions in those benefits. The government should also insist that management eliminate dividends and restrain salaries until the firms return to profitability. Even creditors should have to accept write-downs in the value of their debts.

The government has substantial leverage to ensure that these changes occur. The auto companies' management, unions, trustees of retiree benefits, and creditors would recognize that without government assistance the firms would be forced into bankruptcy and that the bankruptcy court could require even more severe cuts in incomes, benefits, and payments to shareholders and creditors.

Administering bitter medicine is difficult for politicians. President Bush would do his successor a favor by forcing such a restructuring. It would relieve Obama of his promise to help the auto companies in a way that improves prospects for the American automobile industry.

Martin Feldstein is a member of AEI's Council of Academic Advisers. A version of this article appeared in the *Washington Post* on November 18, 2008.

Recession Will Be Less Damaging without Bailouts

By Kevin A. Hassett

When times are bad, you find out who you are. In some sense, economics is like sports. Sometimes you get slaughtered, but if you believe in yourself and keep fighting, you can win again.

A look at U.S. history suggests that even during the worst U.S. recessions, Americans have been able to turn things around. There were times when things looked so bleak that only a fool might have hoped for a brighter future. Eventually, that brighter future arrived.

Yes, a pessimist might say, but this time things are much worse. I am not so sure they have to be, provided we remember who we are.

Things are certainly bad. It looks like third-quarter GDP growth will be revised deep into negative territory. The data in hand suggest that fourth-quarter GDP will drop at a rate of as much as 4 percent.

The consensus of many forecasters is that this fourth quarter will be the worst in this recession, that the economy will begin inching away from the abyss next year. The latest read on the first quarter of 2009, for example, at Moody's Economy.com, is that the economy will decline about 2 percent, with smaller declines thereafter.

While there are no guarantees, this suggests that the recession may not dive into economic territory that is wholly unfamiliar to us. If that is true, why the 1930s-style rush to big government?

Although the last two recessions were mild, most recessions in the post-World War II period saw GDP declines that were larger than those now predicted. The recession of 1948-49 lasted almost five quarters, and two of them saw real GDP decline by more than 4 percent, based on an annualized rate. In the 1953 recession, there was a quarter in which real GDP dropped by more than 6 percent by that same measure. The largest such decline since 1947—more than 10 percent—took place in the first quarter of 1958.

In the 1960 and 1974 recessions, there were quarterly drops of about 5 percent on an annualized basis. In the 1980 recession, there was an almost 8 percent annualized drop in one quarter, and in 1981, two successive quarters posted drops of 4.9 percent and 6.4 percent.

A look back at those terrible times is heartening. Even with those setbacks, the economy grew on average 3.4 percent per year between 1947 and this year's third quarter.

Why did things always work out in the end? Because we remembered who we were when times got tough. The United States has always distinguished itself relative to its major trading partners by having a higher faith in free markets and a greater respect for the limits of big government. Sure, the United States passed a stimulus package now and then, but it also let failure run its course and refused to resort to excessive big-government intrusions into the private sector.

The risk is that we will forget this lesson. First, we bailed out the financial companies. Now Obama is asking for \$50 billion to bail out the auto companies, an effort backed by Treasury Secretary Henry Paulson. Next, we will see a tax credit for people who buy GM cars at stores of bankrupt retailer Circuit City, provided they use the car to go to a Detroit Lions game.

A look at economic history suggests that the crazy policy intrusions have to stop. Failure can be a good thing, and recessions force economic stragglers to make tough decisions. Those tough decisions set the stage for the recovery.

GM, for example, makes some good cars and some bad. It has twenty-one plants now operating in North America and plans to close three, but probably needs to close a lot more.

As it does, its sales will have a harder and harder time supporting the excessively generous benefits the company promised workers. We have a place where creditors and

workers iron out messes like this through renegotiation and reorganization. It is called bankruptcy.

To hear the bailout people talk, you would think that taking a firm to bankruptcy is akin to sending it to the mortuary. That is false. Bankruptcy is more like intensive care. It is where we have always sent our sickest companies.

Sending taxpayer money to GM will not help it in the long run. Our economy will be saddled with tossing resources at a struggling company indefinitely. The sooner GM reorganizes and becomes more efficient, the sooner our economy will begin heading in the right direction.

Like the recessions of the past, this one will end. Our economy will be stronger, sooner, if we let the healing process begin.

Kevin A. Hassett is a senior fellow and the director of economic policy studies at AEI. A version of this article appeared on Bloomberg.com on November 17, 2008.

Stimulate Car-Buyers, Not Carmakers

By Robert W. Hahn and Peter Passell

Should Uncle Sam save GM, Ford, and Chrysler from bankruptcy? In normal times, most mainstream economists—and many mainstream legislators—would probably say no. But with financial markets in turmoil and the economy on the cusp of a nasty recession, these are hardly normal times. In any event, Congress and Obama are committed to spending billions to keep the Big Three afloat.

What has not been decided, however, is how that money should be spent. A radical change in perspective could spare the nation a lot of grief down the road. Rather than subsidizing the automakers directly—and almost certainly sucking Washington into their management—why not give Americans the financial incentive to accelerate purchases of cars and light trucks? The consumer-subsidy approach would be a less wasteful route to the desired end, as well as one that would leave a less toxic legacy of market intervention once the economy has recovered.

While the details of the bailout have yet to be hammered out, all signs point to loan guarantees conditioned on concessions from the stakeholders—perhaps cuts in union and white-collar compensation—surely restructured bank debt, and maybe a shotgun wedding between

Chrysler and GM. This would keep the industry alive and most of its workers employed—for a while.

Even if the industry recovers with a lot of help from its friends, however, the price will be high. At best, the arrangement will inevitably tighten the all-too-cozy relationship between Washington and Detroit in matters of technology, pensions, fuel efficiency, and environmental regulation, as well as open the door to bailouts of equally worthy industries in distress. At worst, it will suck the taxpayers into the next automobile crisis, and the next.

Since a big fiscal stimulus package for fighting the recession—some combination of tax cuts, extended unemployment compensation, infrastructure grants, and assistance to states—is coming soon, why not stimulate consumers to buy cars? Why not offer eye-popping rebates—say, \$3,000—for a limited time to buyers of cars and light trucks? It would probably make sense to phase out rebates for the most expensive cars, and, as a treaty obligation, it would not do to discriminate against foreign makes.

How much downstream benefit this would generate and for whom is hard to predict. Still, it is a fair bet that most of the money would be quickly recycled in the form

of demand for everything from auto parts to car mechanics' salaries—just what you want to happen in a recession.

If, say, 12 million nonluxury vehicles were sold next year—similar to 2007—the rebates would total \$36 billion. Of that sum, about one-half would go for cars built by the Big Three. Better yet, more than 80 percent could be expected to go for vehicles actually manufactured in North America, even if the automaker is from overseas.

This is not a perfect solution. The rebates would have to be phased out so that sales do not drop off a cliff the day after the deadline. Not to mention that

it is far from clear that it ever makes economic sense to favor one industry over another during hard economic times.

But some form of aid to the auto industry seems to be politically inevitable. It would be nice to manage the task with maximum benefit to middle-income Americans—and minimal micromanagement by Washington.

Robert W. Hahn is a senior fellow at AEI and the executive director of the AEI Reg-Markets Center. Peter Passell is a senior fellow at the Milken Institute. A version of this article appeared in the *Wall Street Journal* on November 15, 2008.

Stop the Green Carjacking

By Kenneth P. Green

Always eager to shove their agenda into a seemingly unrelated policy discussion, the green movement has joined the debate over bailing out the Big Three automakers. House Speaker Nancy Pelosi (D-Calif.) wants to tie federal assistance to a requirement that Detroit make more fuel-efficient, eco-friendly cars.

“Any car company that gets taxpayer money must demonstrate a plan for transforming every vehicle in its fleet to a hybrid-electric engine with flex-fuel capability, so its entire fleet can also run on next generation cellulosic ethanol,” demands *New York Times* columnist Thomas Friedman. Writing in the *Washington Post*, Columbia University economist Jeffrey Sachs calls for a “major industry restructuring to position the United States to lead the world in producing cars that get 100 miles or more per gallon.” (Sachs is pinning his hopes on plug-in hybrid vehicles, “fuel-cell cars,” and the much-ballyhooed—but not yet seen or priced—Chevy Volt.)

In other words, at a time when the top Detroit automakers are desperate for financial aid, the federal government should force them to sell more expensive cars that are less profitable. Make sense to you? Me neither.

It is hard to see how “greening” Detroit will help car companies, car drivers, or American taxpayers. Greener vehicles are more expensive to make and bring in less profit than other cars. They cost more to finance, more to repair, and more to insure. Their sales depend heavily on tax incentives—which means that selling more of them will require more taxpayer dollars. The National Renewable Energy Laboratory estimates that plug-in hybrid vehicles cost \$3,000-\$7,000 more than regular hybrids, even

though the performance differences between the two models are slight, and the really fuel-efficient hybrids cost \$12,000-\$18,000 more than the conventional brand.

Consider the Chevy Volt. When it was first announced, the price estimate from GM was \$30,000. That soon jumped to \$35,000. Now GM's president says that the actual price could be closer to \$40,000 and that GM will still lose money on the sale. As for fuel cells, GM's prototype fuel-cell car runs on hydrogen and emits nothing but water vapor. It is hard to get greener than that—but it is also hard to find a more expensive car: the prototypes cost \$1.5 million to produce.

Hybrids are also more expensive to insure. Online insurance broker Insure.com shows that it costs \$1,374 to insure a Honda Civic but \$1,427 to insure a Honda Civic Hybrid. Similarly, it costs \$1,304 to insure a Toyota Camry but \$1,628 to insure a Toyota Camry Hybrid.

If the green movement succeeds in carjacking the Detroit bailout, automakers will be forced to sell costlier and less profitable vehicles.

What explains the higher rates? According to State Farm, hybrids cost more to insure because their parts are more expensive and repairing them requires specialized labor, thus boosting the after-accident payout. Even conventional small cars are more expensive to insure than larger vehicles because the former are involved in more accidents that produce extensive

injuries. According to a recent article in the *Wall Street Journal*, the same driver would pay \$412 more to insure a Honda Civic compact that gets thirty-six miles per gallon (MPG) on the highway than he would to insure a Honda CR-V (Honda's mini-SUV) that gets twenty-six MPG.

President-elect Barack Obama wants to give a \$7,000 tax credit to Americans who buy a plug-in hybrid vehicle. He says that such a tax credit will help carmakers sell a million plug-in hybrids over the next seven years. If Obama is right, that means the government will spend around \$7 billion in taxpayer money to promote the sale of plug-in hybrids. Replacing all American cars with plug-in hybrids would require tax incentives worth roughly \$1.8 trillion dollars (assuming each car would cost the government \$7,000).

If the green movement succeeds in carjacking the Detroit bailout, automakers will be forced to sell costlier and less profitable vehicles. Before allowing that to happen, policymakers should consider the consequences of higher car prices—namely, reduced sales, slower fleet turnover, and longer operation of aging vehicles that emit more pollution and break down more frequently than newer automobiles.

They should also consider how higher car prices will affect Americans in the midst of a nasty—and possibly long—recession. Finally, they should ask themselves: is this really the way to make U.S. automakers more financially secure and globally competitive?

Kenneth P. Green is a resident scholar at AEI. A version of this article appeared on *The American* on November 20, 2008.