Introduction

For more than a century, the auto industry has been at the center of U.S. manufacturing. It has provided jobs to millions of people, wealth to tens of millions, and products by the hundreds of millions. The jobs it has created have been high quality jobs: They have taught skills, promoted mobility into the middle class, and provided health care and retirement security to generations of Americans.

The industry’s products have been icons of their times—practical but also central to the American dream of freedom and mobility. The wealth that the industry has created has enriched not just the companies’ owners and managers, but also workers and suppliers in communities everywhere. The industry was the economic foundation for a vibrant and integrated Detroit for much of the 20th century, serving as a magnet for large numbers of people who came searching for jobs and economic security.

This is an extraordinary record of private achievement and public responsibility unmatched by any other industry in this or any country.

But over time the U.S. auto industry lost its way. It squandered its competitive
advantage. It did not respond to changes in consumer preferences and in technology. It allowed itself to become vulnerable to outside forces. It retreated from market after market, shrinking and seemingly settling for a long slow decline. The companies, their unions, and their communities all seemed resigned to this glide path, seeking only to slow its pace in order to minimize its adverse effects on all parties.

But even that modest--and depressing--plan was overtaken by events. With the onset of the financial crisis in 2008, industry sales suddenly collapsed, especially for the large vehicles on which the U.S. industry was focused. Credit dried up, household income fell, and unemployment soared. GM, Ford, and Chrysler—the old Big 3—watched their sales fall by 40-50% and their losses exploded. With all that, the industry veered off its glide path to smaller size, and stared into the abyss of its complete demise. And there were no private agents to rescue it. Not its management—which was never Detroit’s strong point. Not its unions—they have never been very far-sighted. Not its creditors—they were in trouble themselves and viewed Detroit’s prospects with justifiable wariness.

At that point, there were basically two policy alternatives: The free-market solution, advocated by many, would be to allow the companies to enter into bankruptcy, followed undoubtedly by their partial liquidation and the eventual emergence of smaller (potentially much smaller) transformed enterprises. The alternative involved short-term government financial support followed by a managed bankruptcy designed to reorganize companies’ finances and resume operations as quickly as possible so as not to lose customers, suppliers, and workers permanently.

The last administration, which did not want the industry to collapse on its watch,
provided short-term financial support to the auto companies. But it had no long-term plan for
the industry, opting instead to hand the hot potato to the incoming administration.

Speed was clearly essential, and so when the Obama administration took office, it moved
very quickly:

• It established a Supplier Support Program that guaranteed payments to GM’s and
  Chrysler’s Tier 1 suppliers—essentially their largest suppliers, such as TRW, Visteon, and
  American Axle.

• It established as Warranty Commitment Program that created an industry-funded and
government-guaranteed facility that would pay for warranty repairs during restructuring.

• It forced out GM’s CEO and installed new management.

• It forced first Chrysler and then GM into bankruptcy proceedings that, against all the
  odds and expectations, were concluded within about 35 days each.

Emergence from bankruptcy required major financial and operating concessions from all
players, agreement on the structure of the new companies, and the installation of new board
members. GM, for example, was to shed half its brands, close 13 of its 47 auto plants, cut one-
third of its workforce, terminate nearly 2000 dealerships, revise its health and retirement plans,
replace its management, and install new board members. In trade, it got a substantial additional
cash infusion, enough, it was said, to allow it to re-engineer its product line-up and otherwise to
restructure itself for a different era of auto manufacturing. The U.S. government took a 60
percent ownership stake in the new GM, while the UAW retirement fund holds a 17.5 percent
nonvoting interest. The remainder is in the hands of the Canadian government and former
bondholders whose debt was converted to equity.
Chrysler underwent a similar transformation. It was also required to close plants, terminate dealerships, cut its labor force and their wage scales, and revise its health and retirement plans. It, too, got government cash, in return for which it became 55 percent owned by the UAW retirement fund (again non-voting), 35 percent by Fiat, 8 percent by the U.S. government, and 2 percent by the Canadian government.

To complete the story, we must add a word on Ford. Ford’s sales collapsed just as GM’s and Chrysler’s. Its losses were no less substantial. But two years earlier Ford had brought in new management, restructured its debt, and taken other actions that fortuitously had insulated it from the imminent financial dangers faced by GM and Chrysler. It was able to fund itself through the downturn without the need to go to the capital markets or the government for support. Ford now represents something of a contrasting experience to its Detroit brethren. (I shall return to the Ford story later on.)

As a result of these changes, the industry would never again look the same. The so-called Big 3 were gone. What was left were three chastened and smaller firms, two with substantial government and union ownership, facing—finally—the need for radical reform. Suppliers, workers, communities everywhere—Detroit in particular—were and now are facing wrenching adjustments.

**Past Government Intervention**

There was, of course, much debate about the rationale and merits of government intervention. But government involvement in the private sector was scarcely novel: From the Eire Canal to the interstate highway system, the government has long been deeply involved in various sectors of the economy. With agriculture and airlines, it has long subsidized companies
in the supposed private sector. With Lockheed and PennCentral, it has periodically intervened to prevent collapse of major companies. And perhaps most famously, thirty years ago Chrysler received what was then termed a federal bailout to prevent its imminent bankruptcy.

The reasons for Chrysler’s plight are all too familiar, as are the arguments about government intervention. During the 1970s Chrysler suffered from poor products, costly production, and management mistakes. The recession of the late 1970s caused a precipitous loss of sales and huge losses that threatened its viability. Some argued that Chrysler’s problems were of its own making, and so it should suffer the consequences—let it go belly up. Others alluded to estimates of large job losses, disruptions to the regional economy, and poor prospects for the company’s renewal as reasons for intervention.

The arguments for federal government intervention into Chrysler proved persuasive. The Chrysler Loan Guarantee Act of 1979 provided what was then the staggering sum of $1.2 billion in federally guaranteed loans. In trade Chrysler had to secure various concessions from its workers, suppliers, banks, local communities, and dealers, and agree to a federal oversight board.

At one level, the federal government intervention into Chrysler could be described as a success. It provided crucial financial resources that were not available from any other source. It helped the company get past the industry sales decline until the economic recovery of the early 1980s. In short, it allowed Chrysler to survive intact.

On the other hand, “success” may be too strong a term for the longer-term consequences of the bailout. Chrysler did not have to fundamentally change its management, or its UAW contract, or its relationship with its suppliers, or its health and pension obligations, or or its products. It was the recovery of the overall market, rather than fundamental internal change, that
saved the company.

The bailout arguably just postponed the day of reckoning—by 30 years, to be sure, but not really changing the final outcome. Perhaps worse yet, the bailout may have given credence to the notion that some companies and industries simply would not be permitted to fail. Their size and interconnectedness create a public interest that transcends their private roles. These are issues with echoes in the current policy toward auto industry.

So, as the financial meltdown of 2008 burst upon us, past experience had already taught several lessons about government intervention:

1. Government intervention into the private sector has many precedents.
2. Some companies and industries are not likely to be allowed to fail.
3. The record of targeted and temporary government intervention has been reasonably successful in forestalling immediate collapse.
4. The record of such intervention in bringing about fundamental change in a company or industry has been more problematic.
5. And, finally, intervention may foster expectations of future assistance to industries in trouble.

**Current Auto Policy**

None of these lessons were lost on the Obama administration in fashioning its plan for the auto industry. Most importantly, while its plan provided the necessary transition assistance to suppliers, customers, workers, and communities, it also sought to ensure that its assistance to the companies was accompanied by fundamental change in their operations, rather than simply allowing them to resume their prior activities once their fortunes stabilized and the government
withdrew. Thus, the administration forced out GM’s CEO, pressed for changes on its board, insisted that Chrysler find a partner, and required downsizing of both companies’ operations, dealer networks, and product line-ups.

These were the acts not taken in the earlier Chrysler case. But they are the acts necessary for the longer-term transformation of the companies. And they reflect the view—correct, I believe—that if government is going to provide financial assistance, it should be sure that the companies undergo real change. After all, any lender could and would impose tough conditions on a loan to a company in such difficult circumstances. It may be politically safer to kick the can down the road, but it is bad policy.

To be sure, the administration’s strategy entails considerable risk, both operational and political. Operationally, it raises the concern that some of these decisions may simply prove to be wrong, and badly so. What if Fiat turns out to be an poor partner for Chrysler? What if the new small cars pushed by the Administration do not sell? What if no board can turn GM around? What if the problems are truly intractable?

Recall, after all, that over the years no lesser figures than Ross Perot and Kirk Kerkorian have tried to take control of GM and reform it. But both had ultimately thrown up their hands in exasperation and walked away. While neither of those had the ability to require fundamental change (as does the government now), their experiences might nevertheless prompt a certain amount of humility.

The other risk is political. By becoming deeply involved in GM and Chrysler, the administration has assumed much greater responsibility for the outcome than would a normal lender or even the federal government in the earlier Chrysler case: This administration now
“owns” the issue. If intervention succeeds, it will get some of the credit. But if it fails, there will be no end to the adverse political fallout.

And the administration is not in control of events. The auto market is showing signs of recovery, but it won’t return to the levels of the early 2000s anytime soon. The technology for mass produced fuel efficient vehicles could be three years away or thirteen. Consumers may be interested in the new vehicles or not, in which case there is big trouble for the industry. New management may be stronger than the old, but the challenges are much greater as well, and they may stumble.

There is another feature of auto policy that is not in the control of the administration, namely, Congress. The president has stated that his administration has no interest in... running GM. GM will be run by a private board of directors and management team with a track record in American manufacturing that reflects a commitment to innovation and quality. They, and not the government, will call the shots and make the decisions about how to turn this company around. The federal government will refrain from exercising its rights as a shareholder in all but the most fundamental corporate decisions.

This is, of course, exactly the right principle, and by all accounts the executive branch has largely (if not perfectly) held to this standard.

Congress is another matter. In just the past year, one congressman intervened to postpone closure of a GM distribution center in his district. Two senators (one from each party) requested the Treasury to “study” GM’s and Chrysler’s planned dealer closures. Congress has “questioned” GM’s shift to nonunion car haulers and to a foreign source of palladium. GM and Chrysler yielded to congressional pressure, proposed binding arbitration for terminated dealers, and restored several hundred, but even that did not stop Congress from adding language to a bill that would require a “balancing” of interests for any dealer closing.
And if there were any doubt about Congress’s view of matters, the Republican congressman whose district includes the sole domestic supplier of palladium called for hearings into GM’s plan to switch suppliers, saying that GM “ought to be subject to the same rigorous oversight we exercise over any other government agency.”

By contrast, in the statement that I quoted in part above, the President stated that “To get GM back on its feet, [we should] take a hands-off approach and get out quickly.” This is the correct approach— institute reforms, install good management, leave that management alone, and withdraw ASAP.

The Public Stake

This is an appropriate juncture to ask some questions about this administration’s actions with respect to the auto industry. Do they represent an emerging redefinition of the role of the federal government with respect to private industry? Or is it an anomaly that arises once in a generation? How has it worked in practice thus far? And, of course, how will it end?

In one sense this experience is clearly an anomaly. This administration was not looking for companies and industries to take over. It intervened only when it was obvious that GM and Chrysler were sliding toward some chaotic alternative ending that no one else could prevent. Moreover, this exercise in government ownership will surely be temporary.

But this takeover is also different from those in the past. Rather than simply providing financial assistance to the companies, as was standard practice, the administration has insisted on fundamental reforms of the companies. As I said, this ups the stakes—it has the potential for greater benefit, but is accompanied by greater risk.

What about the precedent it sets? What about moral hazard—a term that made its way
from the economics and finance literature to the public vocabulary in the last two years? Clearly, bailing out any company creates an expectation of future intervention that may induce companies to take risks they otherwise would not. But by insisting on major restructuring--starting with deposing the CEO, other senior management, and many board members--this administration arguably has done what it could to make bailouts unattractive to the companies. Senior management in other companies may now believe that their companies will be saved, but they are on notice that their jobs are not likely to survive. That may help keep their incentives from being as distorted as would be the case if, say, the administration had simply sent checks to GM and Chrysler, and wished them well.

How has government ownership worked? Recall that the federal government owns a majority stake in GM but only 8 percent of Chrysler. Through its pension fund, the UAW owns about one-sixth of GM and one-third of Chrysler, but in each case its stake is nonvoting. The Canadian government owns small shares of both GM and Chrysler. And of course, it is Fiat that has controlling interest in Chrysler. So rather than “the Detroit 3,: we now have “the Detroit, Washington, Ottawa, and Turin 3.”

Fiat is exercising the prerogatives of majority ownership, as intended and without objection from any source. The federal government in particular has been almost entirely silent with respect to Chrysler (the exception being congressional meddling with dealership termination). As for GM, while the government has a majority ownership interest, after setting sweeping initial conditions, it has exercised considerable restraint with respect to company strategy. The administration’s position might be described by the term “silent financial interest.”

Under silent financial interest, an ownership stake is not used to affect actual business
decision-making. Rather, those business decisions are left to management. Of course, management knows who its owners are and arguably might take actions beneficial to it, but under the circumstances, silent financial interest may be the best that can be achieved.

Looking ahead, how will these experiences end? If all goes well, it will end not with a bang but with a whimper. GM is planning to pay off some of its loans from the federal government (although there is some debate about how it proposes to do so). Chrysler no doubt will do so in time as well. If all goes well, or at least well enough, both companies will return fully to the private sector, restructured and better prepared for a new auto market, and also unencumbered by outside meddling. Such a scenario is not at all implausible, and seemingly would represent successful examples of targeted and temporary government intervention in the market economy.

Two further comments on Ford are in order. First, Ford has found itself in the awkward position of a private company in direct competition with enterprises with majority ownership by governments and/or unions. Even with their silent financial interest and nonvoting stockholdings, GM and Chrysler’s ownership inevitably raises the issue of a distorted playing field. For that reason as well as many others, rapid withdrawal of the government from its ownership role is desirable.

Ford’s experience raises another, somewhat paradoxical, issue. As a result of its prior actions, Ford avoided financial danger, bankruptcy, and government ownership in 2009, but bankruptcy may have permitted GM and Chrysler to make more sweeping changes than Ford. It is therefore possible that Ford may now lag its rivals in some aspects of restructuring and have more difficulty in further transforming itself.
In Conclusion

At a more philosophical level, there is the question as to whether this action reflects some lack of confidence in the market, perhaps even a paradigm shift in business-government relations. In thinking about this, it is important to bear in mind that it was the private sector, with all its supposed virtues, that produced this calamity for the auto industry. The long slow decline of GM and Chrysler into bankruptcy, and of the Detroit auto industry in general, has truly been a failure of the market process. It has been a failure of the managements of some of the largest private enterprises in the country to competently run their companies. It has been the failure of corporate governance, with weak boards protecting entrenched management. It has been repeated failures of capital markets to exercise oversight and prudence instead of providing endless funding to badly run companies. And it has been the failure of unions to understand their longer-term interests.

No one should come away from the auto industry experience with their faith in the market enhanced. Capital markets, the market for corporate control, product markets, labor markets—all these markets failed. In fact, by intervening in the auto industry, the federal government is arguably doing precisely what these markets failed to do—forcing the companies to restructure, reduce costs, and revamp products.

There are of course hazards that accompany this role for the government and so one should wish it used sparingly. But when such powers must be used, one can only hope that it be used as well as it has been by this administration in the case of the U.S. auto industry.