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The Hidden Cost of Auto Bailouts

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OMAN: The hidden cost of auto bailouts

Government takeovers make private investment too risky now

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As what looks to be a bleak election for Democrats approaches, the administration and its allies are understandably eager to hail any silver lining. Recently, they have been touting the $85 billion bailout of GM and Chrysler as a success. White House Chief of Staff Rahm Emanuel has enthused, "The auto (#) rescue is a great example of how the administration's policies helped lead to a turnaround in the industrial base of our country," and E.J. Dionne of The Washington Post has declared, "Big government saved the Malibu." Neither of these claims is true.

To be fair, credit should be given where credit is due. Once the initial bailout plan was approved, the Obama appointees tasked with watching the taxpayers' money have generally let business grown-ups, rather than political hacks, make decisions. The Chevy Volt - an example of the kind of overpriced, subsidy-dependent green technology (#) that makes liberal hearts go pitter-patter - may yet turn out to be an expensive boondoggle, but for the time being, the companies are nominally profitable. It could have been much worse.

The bailout, however, was still an enormous mistake.

In early 2009, both GM and Chrysler had obligations they could never meet and business models that made no sense. This is not an unusual situation for a business to find itself in. Indeed, it is so common that we have a well-established body of law to deal with it. Distressed companies routinely reorganize in bankruptcy, shedding unrealistic obligations and restructuring to attract new capital. It is a painful process but one with clear rules that everyone knows in advance and plans for accordingly.

The bailout did two things. First, it shredded those rules. After contracting to be well to the rear of investors (#) in the bankruptcy line - investors whose money had kept their jobs on life support - the unions got to jump to the head of that line. Promoting the unions in this way did nothing for the long-term health of the auto industry, but it did reward an unfailingly loyal Democratic constituency.

Second, the bailout provided billions of dollars of taxpayer money. Its defenders rightly point out that without an infusion of capital the companies would have failed. There is no reason, however, that this capital needed to come from the U.S. Treasury. One of the great advantages of bankruptcy reorganization is that a company with reasonable prospects of success - once it sheds unrealistic obligations - can get new financing. The system depends crucially, however, on the new creditors having the absolute assurance that the new contracts they make will be respected legally.

In 2009, no investors were willing to provide the capital GM and Chrysler needed. In part, this was because, after decades of incompetence and denial, the companies were in wretched condition. In part it was because of turmoil in the banking system. Overwhelmingly, however, it was because the new administration made it crystal clear that creditors' contracts with GM and Chrysler would not be respected. The unions would be protected, even at the cost (#) of ignoring the ordinary legal rules. Only a fool would invest billions of dollars in such circumstances.

The government's involvement was a self-fulfilling prophecy. Taxpayer money became vital to GM's and Chrysler's continued survival precisely because the presence of taxpayer money understandably scared away private investors. It's impossible to know for sure, but had the companies filed for bankruptcy without the looming threat of government involvement, they very likely could have reorganized successfully.

Well-functioning markets depend decisively on respect for contracts. Investors will put billions of dollars on the line only when they know what the rules are in advance and they know that those rules will be respected. Without investors willing to do this, we are left with the kind of sluggish growth and unemployment we see today. The bailout did not save (#) GM and Chrysler. They could have gone through bankruptcy like everyone else. It did, however, undermine the trust on which successful capitalism depends.

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