

Bailout Honda, Toyota, and Mercedes, Not GM, Ford, and Chrysler

Richard B. McKenzie

Proponents of federal bailouts of the domestic automobile industry appear to have two key objectives. First, they want to save American automobile jobs. Second, they want to reduce the impact of automobiles on global warming – and, coincidentally, the fate of the arctic ice shelf and polar bears.

Of course, the two objectives have a serious element of incompatibility. If the domestic automobile industry is subsidized through bailouts, then there will be more cars on the world's roads pumping out more CO₂ than there would have been if the domestic industry were allowed to contract or fold because of market financial pressures. Nevertheless, the CO₂ effects of the bailouts can be attenuated by legislated demands that more “green” cars (and fewer Hummers) be produced as a condition of getting the bailout dollars.

How best can these two objectives be achieved, given the federal dollars available for bailouts? Both George Bush and Barack Obama are convinced that the only way to go is to place bailout bets on two American auto-makers -- GM and Chrysler – with over \$17 billion already set aside for a rescue effort that, in the end, could easily exceed \$100 billion (some multiple of the firms' market cap). However, that seems like a bailout strategy that has no good end. The Big Two (of Three) are in serious trouble because many American car buyers don't want to buy their offering and because of their noncompetitive cost structures, inflated by their unions' ability to drain the companies' cash flows through higher and higher wages and more

and more fringe benefits. There is a good chance that federal bailout dollars postpone the inevitable, the companies' eventual demise, which means that the American jobs saved will be temporary.

If the country has to have Washington-centric industrial policy (which the Bush and Obama people seem intent on orchestrating), a far better strategy would be for the bailout dollars be spent on proven winners, that is, on the American operations of Honda and Toyota (and maybe even Mercedes). They produce cars by Americans that Americans want because the cars are cheaper (for the quality received), often times get better gas mileage, have higher resale values, and get better gas mileage (pound for pound). There is little doubt that these American car companies (albeit with foreign origins) will survive the current economic troubles, perhaps because they will continue to take market share from the Big Three, with or without bailouts. This is to say that the bailout dollars spent on Honda and Toyota will not be wasted. They can be a solid investment that can pay future dividends in the form an increase in their work forces, greater taxes, and . . . well, even corporate dividends. (Okay, Toyota reported a loss for its most recent fiscal year, but that was one losing year in the last 77 years, and its loss was a mere fraction of the string of annual losses reported by GM for years.)

Honda and Toyota are also the greenest car companies on the planet with their lineups of highly successful hybrids. (Mercedes has dared to produce a midget car, the Smart Car, the fuel economy of which, 46 miles per gallon, rivals that of the most fuel-efficient hybrids.) Many bailout dollars given the Big Two will be used to cover the companies past bad management decisions. Only a few of the dollars will be available to for expanding their lineup of green cars. In the case of Honda and Toyota, all bailout dollars can be used to drop the prices of their green cars and increase their sales – and to spur their green research agendas.

Finally, the tens of thousands of American workers employed at Honda and Toyota earn on average 60 percent of the American workers at the Big Three. This means that bailout dollars spent at Honda and Toyota harbor the prospects of creating (or saving) nearly twice as many American jobs as would be created if the dollars were spent on the Big Two.

Without bailouts, the Big Two's network of suppliers might well collapse, but not totally. Surely, some components of the Big Two can survive without federal dollars and can be sold off at fire sale prices to investors eager to make a go of producing better cars than the Big Two have produced. And with help, Honda and Toyota can expand their sales and increase the count of American jobs in their own American plants and in their networks of American suppliers.

All told, industrial bailouts don't make good economic sense under the best (or worst) of conditions. But if the country must have bailouts, the best bailout strategy has to be placing bets on proven winners, not proven losers.

Richard McKenzie is the Walter B. Gerken Professor of Enterprise and Society in the Merage School of Business at the University of California, Irvine. His most recent book is on *Why Popcorn Costs So Much at the Movies, And Other Pricing Puzzles* (Springer-Copernicus, 2008).