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Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost

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Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost

Abstract

[Excerpt] The American automobile industry has serious financial problems. Corporate executives from the Big Three (General Motors, Ford, and Chrysler) have testified before Congress about their need for federal credit (direct loans and guaranteed loans). This report examines the Chrysler loan guarantee program for possible insights that could assist Members of Congress in evaluating proposals to provide federal credit assistance.

In 1979, Chrysler applied for federal loan guarantees. In 1979 and 1980, the economy was in recession and the price of oil had unexpectedly increased dramatically. However, at that time there was no financial liquidity crisis, as is the case today. Most of the arguments for and against the proposed Chrysler loan guarantee program are relevant to current proposals for credit assistance to the Big Three. For example, in the 1979 debate, proponents argued that the Chrysler loan guarantee would save many jobs. But opponents contended that the financial capital obtained for Chrysler by the proposed loan guarantee would have been used by other firms to expand their productive facilities, output, and employment. Thus, any Chrysler job losses could be offset by gains at other firms.

Provisions in the Chrysler Loan Guarantee Act of 1979 included the establishment of a Chrysler Loan Guarantee Board, extensive federal oversight of Chrysler's operations, detailed reporting requirements by Chrysler's management, shared sacrifice of parties benefiting from the loan guarantee, and protection of the federal government's interest.

Chrysler used federal loan guarantees to borrow \$1.2 billion of the \$1.5 billion available and redeemed its guaranteed loans in 1982. Some critics argued that Chrysler was only able to return to profitability because of the imposition by the U.S. government of "voluntary" import quotas on Japanese vehicles. In 1980, the Chrysler loan guarantee was treated as a contingent liability with no initial cost at the time the guarantee was provided. Because Chrysler repaid all of its guaranteed loans, the U.S. government incurred no budgetary cost. Furthermore, the U.S. government received warrants to buy Chrysler stock, which it subsequently sold at auction to Chrysler for \$311 million. Thus, it can be argued that the U.S. government made a profit from the loan guarantee program.

Currently, the Federal Credit Reform Act requires that the reported budgetary cost of a credit program equal the estimated subsidy costs to the taxpayer at the time the credit is provided. For proposed legislation establishing a new credit program, the Congressional Budget Office is responsible for making the initial estimate of the subsidy cost. Once legislation has been enacted, the Office of Management and Budget estimates the subsidy cost on the credit program. An appropriation for the annual subsidy cost of each credit program is made into a budget account called a "credit program" account. Thus, under today's budgetary rule, legislation providing direct loans or loan guarantees to assist the automobile industry would require the inclusion of the estimated subsidy cost, which would require an appropriation of budget authority.

This report will be updated as issues develop and/or in the event of new legislation.

Keywords

Chrysler, bailout, Congress, public policy, auto industry

Comments

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Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost

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Summary

The American automobile industry has serious financial problems. Corporate executives from the Big Three (General Motors, Ford, and Chrysler) have testified before Congress about their need for federal credit (direct loans and guaranteed loans). This report examines the Chrysler loan guarantee program for possible insights that could assist Members of Congress in evaluating proposals to provide federal credit assistance.

In 1979, Chrysler applied for federal loan guarantees. In 1979 and 1980, the economy was in recession and the price of oil had unexpectedly increased dramatically. However, at that time there was no financial liquidity crisis, as is the case today. Most of the arguments for and against the proposed Chrysler loan guarantee program are relevant to current proposals for credit assistance to the Big Three. For example, in the 1979 debate, proponents argued that the Chrysler loan guarantee would save many jobs. But opponents contended that the financial capital obtained for Chrysler by the proposed loan guarantee would have been used by other firms to expand their productive facilities, output, and employment. Thus, any Chrysler job losses could be offset by gains at other firms.

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The American automobile industry has serious financial problems. Corporate executives from the Big Three (General Motors, Ford, and Chrysler) have testified before Congress about their need for federal credit (direct loans and guaranteed loans). This report examines the Chrysler Corporation Loan Guarantee Act of 1979 for possible insights that could assist Congress in evaluating proposals to provide federal credit assistance.

Background

In the 1960s and 1970s, the Chrysler Corporation had a history of financial instability. During recessionary periods it had incurred large losses, but during periods of prosperity the corporation had usually earned high profits. Yet between 1967 and 1980, the company's domestic market share had declined from 16% to 8.6%, arguably due to managerial errors, foreign competition, regulatory controls, and the energy shortage at that time.

Chrysler failed to introduce a small car in the late 1960s, even though Ford produced the Pinto and General Motors began manufacturing its Vega. Chrysler refused to manufacture a new small automobile until it introduced its Plymouth Horizon and Dodge Omni models in 1977. The rising cost of gasoline, changing consumer tastes, and Environmental Protection Agency's (EPA's) fuel-efficiency standards contributed to Chrysler's troubles, because it had not shifted its production to smaller vehicles. Some corporate financial experts assert that Chrysler should have reduced its dividends in the early 1970s and used the funds to modernize its plant and equipment. Also, Chrysler made a belated attempt to compete overseas with Ford and General Motors, which was unsuccessful.

In 1979, huge losses compelled Chrysler to sell off some of its subsidiaries, close plants, and reduce its employment. In July 1979, Chrysler requested and subsequently received federal loan guarantees to avoid bankruptcy. Losses continued throughout 1979, and Chrysler's total loss for the year was \$1.126 billion.¹

Ford and General Motors were in better financial condition than Chrysler, but also experienced large losses in 1979 and 1980 because of the sharp rise in the price of gasoline and the worst economic downturn since the Great Depression. "In 1980, the Big Three [General Motors, Ford, and Chrysler] lost a record \$4.2 billion as their sales in that year plummeted 30% below 1978 sales, reaching their lowest level since 1961."² As will be discussed in a subsequent section of this report, in 1981, the Big Three advocated and received the imposition by the federal government of "voluntary" import quotas on Japanese vehicles. These "voluntary" import quotas contributed to the return to profitability of General Motors and Ford, as well as Chrysler.

¹ U.S. General Accounting Office, *Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO Report GGD-84-34, March 29, 1984, p. 15.

² Stephen D. Cohen, *The Route to Japan's Voluntary Export Restraints on Automobiles*, Working Paper No. 20, School of International Service, American University, p. 2. Available at <http://www.gwu.edu/~nsarchiv/japan/scohenwp.htm>, visited Dec. 1, 2008.

Arguments For and Against the Guarantee

Advocates of the loan guarantees advanced four primary arguments. First, if Chrysler defaulted there would be an enormous loss in employment. Many of these job losses would occur in firms supplying parts and materials to Chrysler. Data Resources Inc. conducted a simulation of the Chrysler collapse and concluded that there would be a 500,000 near-term loss in employment and a longer-term additional employment loss of between 200,000 and 300,000. Second, some of Chrysler's difficulties were beyond its control, particularly large price increases in oil obtained by the Organization of Petroleum Exporting Countries. Third, federal safety, environmental, and fuel efficiency standards had been disproportionately costly for Chrysler compared to General Motors and Ford, because the larger corporations had longer production runs and thus could spread out their regulatory costs over more units. Consequently, Chrysler "deserved" federal compensation for its costs incurred in meeting federal regulations. Fourth, Chrysler manufactured the main battle tank for the U.S. Army; hence, if Chrysler went bankrupt national defense would be weakened.

Opponents of the loan guarantee to Chrysler buttressed their case with five basic arguments. First, they contended that the analysis made by Data Resources Inc. was misleading. The financial capital which Chrysler would obtain with the loan guarantee could be used instead by other firms to expand their productive facilities, output, and employment. In addition, part of Chrysler's lost sales would be picked up by General Motors and Ford. Second, the entire economy was experiencing high energy costs; thus a single firm such as Chrysler did not warrant preferential treatment due to the energy problem. Third, most of the regulatory costs incurred by Chrysler were due to fuel-efficiency standards. Yet Chrysler would have been compelled to improve the average mileage of its automobiles anyway, because of the rising cost of energy. Fourth, if Chrysler went bankrupt it would go into receivership under existing bankruptcy legislation. Profitable operations, such as its tank production division, would continue as a subsidiary of another corporation or as a new corporation. Fifth, the Chrysler loan guarantee might encourage other large corporations to obtain federal financial assistance. This would lead to a greater federal role in the economy and a reduction in the efficiency of private capital markets in allocating credit.

Major Provisions of the Loan Guarantee Act

In January 1980, Chrysler Corporation Loan Guarantee Act of 1979 (the Act) was signed into law as P.L. 96-185. The Act included numerous provisions, which are summarized as follows:³

- The Act established the Chrysler Corporation Loan Guarantee Board (the Board), which was composed of the Secretary of the Treasury (chairperson of the Board), the Chairman of the Board of Governors of the Federal Reserve System, and the Comptroller General of the United States. The Secretary of Labor and the Secretary of Transportation served as ex officio nonvoting members of the Board.

³ The provisions described in this section of this report are from the following source: U.S. Congress, House, *Chrysler Corporation Loan Guarantee Act of 1979*, Conference report no. 96-730 (to accompany H.R. 5860), Washington, Dec. 20, 1979, 19 p.

- The Board was responsible for determining the terms and conditions under which it would make commitments to guarantee the payment of principal and interest on loans to Chrysler if the Board determined that (1) Chrysler had an energy-saving plan satisfactory to the Board, (2) the loan guarantee was necessary to prevent serious negative effects of the economy, (3) Chrysler had submitted a satisfactory operating plan, and (4) Chrysler had submitted to the Board a satisfactory financing plan to meet the financing needs of the operating plan and which included an aggregate amount of nonfederally guaranteed assistance of at least \$1.43 billion from Chrysler, banks, financial institutions, other creditors, suppliers, dealers, stockholders, labor unions, employees, management, state and local and governments, and others directly deriving benefit from the production, distribution, or sale of the products of Chrysler.
- A loan guarantee could be issued only if the Board determined that (1) credit was not otherwise available to Chrysler under reasonable terms or conditions, (2) Chrysler's prospective earning power and the value of the security pledged had to furnish reasonable assurance of the repayment of the guaranteed loan, (3) the loan to be guaranteed had an interest rate determined by the Board to be reasonable, (4) Chrysler's operating and financing plans continued to meet Board requirements, (5) Chrysler was in compliance with its operating and financing plans, (6) the Board had received assurances that Chrysler's operating and financing plans are realistic and feasible, (7) Chrysler agreed to reporting requirements of a revised operating and financial plan covering the period of the loan guarantee; and within 120 days following the close of each fiscal year, an analysis reconciling the corporation's actual performance with the operating and financial plan was submitted, (8) there was no substantial likelihood that Chrysler would be absorbed by or merged with any foreign entity, and (9) Chrysler was in compliance with the terms and conditions of the commitment to issue the guarantees required by the Board. Any determination by the Board that the conditions established by the Act had been met would be conclusive. The Board would prescribe and collect a guarantee fee sufficient to compensate the federal government for all administrative expenses related to the guarantee but in no case could such fee be less than one-half of 1% per annum of the outstanding principal amount of loans guaranteed. The Board was to ensure that the federal government is compensated for the risk assumed in making guarantees. Thus, the Board was authorized to collect an additional fee above the fee to cover administrative costs, to enter into contracts allowing the federal government to participate in gains from the financial success of Chrysler, or use instruments deemed appropriate by the Board. All amounts collected by the Board would be deposited in the Treasury as miscellaneous receipts.
- The Act described the proportionate share to be contributed by employees in order for Chrysler to receive the loan guarantees.
- The Act required Chrysler to establish an employee stock ownership plan (ESOP).
- The amount of loan guarantees could not at any time exceed \$1.5 billion in aggregate principal amount outstanding.
- Loans guaranteed under the Act would be payable in full not later than December 31, 1990.

- The Board was authorized to inspect and copy all accounts, books, records, memoranda, correspondence, and other documents and transactions of Chrysler.
- In order to protect the federal government's interest, the Board was granted extensive oversight authority including approval of the sale of any asset with a value in excess of \$5 million and a labor contract having an aggregate value of future wages and benefits of \$10 million or more. Debts owed the federal government would have priority, but the Board could wave such priority.
- The Secretary of Transportation would submit to the Board and to Congress a planning study providing an assessment of the long-term viability of Chrysler's involvement in the automobile industry.
- The Board would submit reports to Congress semiannually for 1980 and 1981 and annually for later years.
- The authority of the Board to issue loan guarantees was to expire on December 31, 1983.
- The administrator of the Small Business Administration would investigate whether or not small-business automobile dealers should receive federal loans and loan guarantees.
- The Act included amendments to the Electric and Hybrid Vehicle Research, Development, and Demonstration Act of 1976.

Results of Loan Guarantee

Chrysler used \$1.2 billion of the \$1.5 billion in loan guarantees. The corporation downsized its operations and returned to profitability. "The restructuring took place fairly quickly with less interruption of the firm's operations than would have occurred in a bankruptcy."⁴ In 1982, Chrysler was profitable and redeemed its government guaranteed notes in June and August of that year.⁵

"Voluntary" Import Quotas

Some critics argue that Chrysler was able to return to profitability because of the imposition by the U.S. government of "voluntary" import quotas on Japanese automobiles, which were negotiated by the Reagan Administration and announced by the Japanese government on May 1, 1981. The Big Three and the United Automobile Workers advocated for restrictions on Japanese automobile imports. Supporters of quotas in the Reagan Administration argued that the American automobile industry needed temporary restraints on imports in order to permit "breathing room" for the Big Three to retool their factories for the production of more fuel efficient vehicles.⁶ The "voluntary" import quotas provided financial benefits to the Big Three and American workers in

⁴ U.S. General Accounting Office, *Guidelines for Rescuing Large Failing Firms and Municipalities*, p. 18.

⁵ *Ibid.*, p. 17.

⁶ Stephen D. Cohen, p. 6.

the automobile industry. But, major Japanese manufacturers realized “windfall” profits and American consumers paid higher prices for vehicles.⁷

Budgetary Cost of Guarantee

Before FY1992, federal loan guarantees were treated as a contingent liability of the U.S. government. Thus, at the time a loan guarantee was granted, there was no budgetary cost. Because Chrysler repaid all of its guaranteed loans, no budgetary cost was incurred by the U.S. government. In addition, in return for the loan guarantee, the U.S. government had received from Chrysler 14.4 million warrants to purchase Chrysler stock at \$13 per share until 1990. On September 12, 1983, the U.S. government auctioned these warrants, and Chrysler purchased them for \$311 million.⁸ Thus, it can be argued that, from a budgetary standpoint, the Chrysler loan guarantee program made money for the U.S. government.

Current Budgetary Cost of Federal Credit

The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) added Title V to the Congressional Budget Act.⁹ Title V, also called the Federal Credit Reform Act of 1990 (FCRA), changed how the unified budget reports the cost of federal credit activities (i.e., federal direct loans and loan guarantees).¹⁰ Before FY1992, for a given fiscal year, the budgetary cost of a new direct loan or loan guarantee was the net cash flow for that fiscal year. This cash flow measure did not accurately reflect the true cost of a loan or loan guarantee, which is its subsidy cost over the entire life of the loan or loan guarantee.

Beginning with FY1992, federal credit reform legislation required that the reported budgetary cost of a credit program equal the estimated subsidy costs at the time the credit is provided. The FCRA defines the subsidy cost as “the estimated long-term cost to the government of a direct loan or a loan guarantee, calculated on a net present value basis, excluding administrative costs.” This places the cost of federal credit programs on a budgetary basis equivalent to other federal outlays. This change means, because the subsidy costs of discretionary credit programs are now provided through appropriations acts, the discretionary credit programs must then compete with other discretionary programs on an equal basis. Funding for most mandatory credit programs (generally entitlement programs) is provided by permanent appropriations. For a proposed credit program, the Congressional Budget Office is required to estimate the subsidy cost. If legislation is passed that includes this credit program, the Director of the Office of Management and Budget (OMB) is responsible for coordinating the estimation of subsidy costs.

⁷ Robert W. Crandall, “Import Quotas and the Automobile Industry: The Costs of Protectionism,” *The Brookings Review*, vol. 2, no. 4, summer 1984, pp. 8-16.

⁸ Gary Putka, Chrysler to Pay U.S. \$311 Million for Its Warrants, *Wall Street Journal*, Sept. 13, 1983, p. 3.

⁹ For a comprehensive analysis of the current budgetary treatment of federal credit, see CRS Report RL30346, *Federal Credit Reform: Implementation of the Changed Budgetary Treatment of Direct Loans and Loan Guarantees*, by James M. Bickley.

¹⁰ Currently, the budgetary cost of federal credit does not include market risk. A Congressional Budget Office (CBO) report examined two ways of including the market price for risk: risk-adjusted discount rates and option-pricing methods. CBO made estimates for the cost of the Chrysler loan guarantee using these two methods, which are available in the following report: Congressional Budget Office, *Estimation the Value of Subsidies for Federal Loans and Loan Guarantees*, Aug. 2004, 27 p.

An appropriation for the annual subsidy cost of each credit program is made into a budget account called a *credit program account*. Funding for the subsidy costs of discretionary credit programs is provided in appropriation acts and must compete with other discretionary programs for funding available under the constraints of the budget resolution. Most mandatory credit programs receive automatic funding for the amount of credit needed to meet the estimated demand by beneficiaries. Mandatory programs are generally entitlement programs for which the amount of funding depends on eligibility and benefits rules contained in substantive law. The subsidy cost of federal credit is scored as an outlay in the fiscal year in which the credit is disbursed by either the federal government or a private lender [Section 504d]. For mandatory credit programs, any additional cost from reestimates of subsidies for a credit program is covered by permanent indefinite budget authority. This additional cost is displayed in a subaccount in the credit program account.

Also, beginning with FY1992, each credit program has a nonbudget *financing account*. Each of these nonbudget financing accounts receives payments from its associated credit program account equal to the subsidy cost at the time a new loan or loan guarantee is provided. They also acquire the value of the unsubsidized portion of the loans (actual disbursements by the government minus the subsidy cost). These amounts are borrowed from the Treasury through the loan program.¹¹ Furthermore, the financing accounts contain all other cash flows between the public and the government associated with each credit program [Section 502(5E6-7)]. These flows include “the disbursement and repayment of loans, the payment of default losses on guarantees, and the collection of interest and fees.”¹² Because they are nonbudget, the cash flows into and out of these accounts are not reflected in total outlays, receipts, or surplus/deficit. The budget authority of a credit program provides the means for the credit program account to pay to the financing account an amount equal to that program’s estimated subsidy costs. The off budget borrowing from the Treasury for the unsubsidized portion of a credit program is included in the national debt.

Conclusions

This report examined the Chrysler Corporation Loan Guarantee Act of 1979 for possible insights that would assist Congress in evaluating proposals to provide federal credit assistance to the Big Three. In 1979-80, the economy was in recession and the price of oil had unexpectedly increased dramatically. However, there was no financial liquidity crisis, which currently exists. Most of the arguments for and against the proposed Chrysler loan guarantee program are relevant to current proposals for credit assistance. Provisions in the Chrysler Loan Guarantee Act of 1979 included the establishment of a Chrysler Loan Guarantee Board, extensive oversight of Chrysler’s operations, detailed reporting requirements by Chrysler’s management, shared sacrifice of parties benefiting from the guarantee, and protection of the government’s interest. Chrysler borrowed \$1.2 billion of \$1.5 billion available and redeemed its guaranteed loans in 1982. Some critics argued that Chrysler was only able to return to profitability because of the imposition by the U.S. government of “voluntary” import quotas on Japanese vehicles. In 1980, the Chrysler loan guarantee was treated as a contingent liability with no initial cost at the time the guarantee was provided. Currently, the FCRA requires that the reported budgetary cost of a credit program equal

¹¹ These transfers within the government represent transfers of budgetary resources rather than actual financial resources.

¹² U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*, p. 359.

the estimated subsidy costs at the time the credit is provided. For proposed legislation establishing a new credit program, CBO is responsible for making the initial estimate of the subsidy cost. For example,

The Advance Technology Vehicles Manufacturing Loan Program (ATVMLP) was authorized under Section 136 of the Energy Independence and Security Act of 2007 (P.L. 110-140). Congress provided the necessary funding for the loans in a continuing resolution for federal appropriations (P.L. 110-329), approved Sept. 30. The continuing resolution contained provisions to enable automakers to access \$25 billion in government loans to retool assembly lines to make more fuel-efficient vehicles. The resolution, enacted to fund the federal government through March 2009, included \$7.5 billion to cover the cost of the loan program as estimated by the Congressional Budget Office.¹³

Once legislation has been enacted, OMB estimates the subsidy cost on the credit program.

This report's examination of the Chrysler loan guarantee program raises some concerns relevant to today's debate about credit assistance to the Big Three. First, current economic conditions differ for the automobile industry. In 1979, the downturn in automobile sales for the Big Three appeared temporary. Today, the downturn in automobile sales for the Big Three may be protracted and sales may not recover if brands are eliminated and plants permanently closed. Second, in 1979, the budgetary treatment of loan guarantees and direct loans was on a cash flow basis. A loan guarantee was initially treated as cost free because it was a contingent liability of the U.S. government. Thus, possible future costs of a default were not considered. A direct loan was treated as a direct outlay, which did not consider the repayment of principal and interest. Today the cost of a credit program is the estimated subsidy cost to the taxpayer at the time the credit is provided. Third, in 1979 and 1980, if Chrysler ended automobile manufacturing, part of this decline in employment would have been offset by increased employment by General Motors and Ford. But, today this would not occur because all of the Big Three are in financial trouble and are requesting federal credit assistance.

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¹³ Bureau of National Affairs, *Daily Report for Executives*, no. 216, Nov. 7, 2008, p. A4.