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The Mythology of Domestic Content

by Michael F. Bryan

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them of the shoemaker . . . . What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.

ADAM SMITH

The virtue of free trade is one concept that nearly every economist advocates. With free trade, a nation can produce the goods and services for which it has a comparative advantage and trade for the goods and services that it is less suited to manufacture domestically. Via profits, specialization channels limited economic resources into industries that use those resources most efficiently. Prices of domestic and imported goods and services will consequently fall, while total consumption and investment will increase. In essence, free trade raises the wealth of all nations that embrace it.

Yet, as Thomas Babington wrote over a century ago, "Free trade, one of the greatest blessings which a government can bestow on the country, is in almost every country unpopular." Since 1979, Congress has heard pleas for protectionist legislation from producers of ammonia, shoes, textiles, copper, stainless and specialty steels, sugar, televisions, and machine-tool makers. A protectionist sentiment has become widespread in the automotive industry—an industry that traditionally has favored open trade and railed repeatedly against foreign protectionist efforts. As foreign participation in a domestic industry intensifies, so will the suspicion that competition is destructive to the national economy, particularly among the laborers who are directly threatened. When the Japanese were making early inroads into the U.S. new-car market, the protectionist drive was limited to "buy-American" campaigns. As Japanese proliferation continued, the protectionist effort escalated to "voluntary" Japanese import restrictions.

The more Japanese auto manufacturers demonstrate their ability in the auto manufacturing field, the more we can expect protectionist solutions to evolve. Pending before Congress is a domestic-content bill that would require major foreign-car makers to establish production facilities in the United States. Effectively, the public is being asked again to aid U.S. automotive workers who in 1982 earned 45 percent more hourly than the average manufacturing worker and 67 percent more than the average private nonfarm worker. This *Economic Com-*

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

ation, the net change in total employment because of domestic-content legislation would be a negligible reduction of the U.S. unemployment rate (0.2 percent) three years after enactment. If the Japanese retaliate and restrict U.S. exports to Japan, the net result would be an equally moderate increase in the U.S. unemployment rate of 0.1 percent over the same period. On the basis of these estimates and of economic theory, it would be difficult to justify the domestic-content bill as a means for increasing U.S. employment or reducing our unemployment rate.

> **In this global setting, the domestic-content bill is a modest effort in the direction of seeing to it that the most vulnerable people in the world should not be forced to pay the costs of the most wrenching economic transition in a century—from smokestack capitalism to computerized capitalism.**
>
> **MICHAEL HARRINGTON**

The equity question of an industrial transition is in many ways a more complex, and less economic, issue. American capitalism has indeed been in transition from an industrial base to a service and high-technology base. Manufacturing employment as a percent of total nonagricultural employment has been declining since the early 1950s, but the decline accelerated between 1970 and 1980. As such, the burdens of this transition would fall disproportionately on laborers in the traditional manufacturing fields, with auto making representing an important component. It is clear that protectionist measures can no more prevent these structural changes from occurring than they could have prevented our industrial economy from emerging out of an agrarian economy. Nor should we want them to. If our intention is to cushion the transition for American labor and its resulting structural unemployment, there are transfer strategies that are more effective than slowing economic progress.

As an example, the Trade Act of 1974 provides for federal trade-adjustment assistance when industries are adversely influenced by international competition. The act provides funds for trade readjustment compensation, job retraining, relocation, and other transition expenses when necessary and aids in job search for the unemployed. In addition to typical six-month state unemployment benefits, the unemployment insurance system often allows an additional 26 weeks of benefits in states particularly hard hit with unemployment. Auto workers are further aided with supplemental unemployment compensation from their employers. Redistributing the costs of labor transition from traditional manufacturing such as auto production is one problem that can be dealt with short of attempts to "protect" the U.S. auto worker from the efficient operation of the marketplace.

> **Free trade is what all nations must practice if we are all to prosper. Unfortunately, many of our trading partners do not play fair. Many complex import regulations limit our sales to Japan and elsewhere.**
>
> **U.S. LEGISLATOR**

Another popular fallacy is that the wealth that accrues from trade requires all trading partners to participate freely. Yet, this is simply not the case. Although unrestricted markets for both trading partners improve the welfare of each, the benefits we enjoy from trade do not require mutual participation. For an extreme example, suppose the Japanese were successful in preventing U.S. exports from entering their country, while at the same time the United States allowed unrestrained entry of Japanese subcompacts into this country. It is inevitable that U.S. consumers would enjoy the benefits of economical transportation, while the Japanese would accumulate an increasing flow of U.S. dollars. To the extent that the Japanese would restrict imports, there would be no outlet for U.S. dollars. Essentially, we would be purchasing Japanese imports with nothing more than paper. The dollars that the Japanese would accumulate eventually would be used. Dollar spending by foreigners takes the form of U.S. exports as dollars return to the U.S. goods-producing sector.[6] If foreigners decide not to spend but instead save, the flow of dollars would return to U.S. financial markets as investments in U.S. industrial or government debt. In short, exports should be thought of as a *cost* of international trade, while imports simply represent the revenues to be earned from trade.

Conclusion

International markets are often viewed in a static, or unprogressive, framework; in practice, international markets are dynamic. The comparative advantage now enjoyed by the Japanese in the production of new cars need not be permanent, as demonstrated by the ability of the Japanese to succeed in a market that was once almost exclusively American. The two major hurdles now confronting U.S. auto producers—labor costs and productivity weaknesses—can be overcome in time. A protectionist solution merely provides a further disincentive for making the adjustments necessary to rebuild domestic auto manufacturing into an efficient industry.

Beyond our industrial dilemma, there are compelling reasons, from a national perspective, to endorse international trade. Open trade allows the U.S. economy to achieve consumption and investment levels that would be unattainable in less efficient, closed-door economies. While there may be noneconomic arguments for protectionism, e.g., equity of industrial transition, we should examine the strength of such arguments. We must ask whether protectionist policies justify the economic losses they would inflict and whether our national objectives can be accomplished through less expensive, nonprotectionist avenues. Too often, protectionist advocates merely secure the interests of vocal special-interest groups at the expense of voiceless American consumers. Whether the market is shoes in Adam Smith's day or automobiles today, the principles of free trade are the same.

6. The return of dollars via international exchange markets need not be direct and can occur after intermediate trades between foreign nations.

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mentary examines the issue of free trade in the market for new automobiles, arguing that what is good for the U.S. auto worker is not necessarily good for the United States.

Invasion of the Japanese Imports

In the early 1970s, U.S. auto factories produced primarily large cars, which made up the bulk of the U.S. new-car market. Confronted with rapidly rising gasoline prices (beginning in 1973), American consumers altered their traditional preference for six- and eight-cylinder cars to more economical, fuel-efficient models. In 1982 subcompact cars represented the largest component of the new-car market with a 45 percent share, compared with 20 percent in 1975 and 12 percent in 1965. Unable to retool existing production facilities quickly, domestic auto manufacturers experienced a serious decline in market share. In less than ten years, new-car imports from Japan increased by over 400 percent. To some extent, the growth of small-car sales was cyclically induced, as consumers temporarily adjusted new-car buying patterns to slower income growth. Some of the increase in demand for small cars should slow with economic recovery, as would the demand for Japanese subcompacts. Yet, current consumer tastes and relatively expensive gasoline suggest that the demand for small cars is largely permanent

There has been precedent for the American preference for smaller cars. In the 1950s, two faltering domestic car makers—American Motors (Rambler) and Studebaker-Packard (Lark)—carved a segment from the new-car market with the "compact." Between 1956 and 1959, the Rambler and the Lark increased market share from 1.2 percent to 8.2 percent. Market penetration by the original compacts eventually stimulated a competitive interest from other U.S. car manufacturers. In 1960 compact models were introduced by each of the "Big Three" auto makers—Chrysler (Valiant), Ford (Falcon), and General Motors (Corvair). Because of its early success in compact cars, American Motors survived the retaliatory competition of the other major domestic compacts; Studebaker-Packard did not.

The recent gains by the Japanese into the new-car market, particularly with subcompacts, have fostered a counterattack from domestic car makers. Unlike the 1950s experience, efforts to ward off the small-car competition have been far less successful. General Motors (Chevette, Cavalier), Chrysler (Omni, Horizon), Ford (Escort, Lynx), and American Motors (Spirit, Alliance) have produced cars to challenge the Japanese subcompact stronghold. The American entries either have focused on the "luxury" end of the market or have been unable to unseat Japanese economy-class subcompacts. In January 1982, GM discontinued U.S. production plans for the S-car, a major small-car line; soon after, GM announced plans to import up to 200,000 subcompact cars from the Japanese.

Why are the U.S. auto makers losing ground in subcompact-car production? To begin with, Japanese auto-production standards are viewed by many as qualitatively superior to U.S. auto-production standards. In addition, Japanese auto manufacturing costs are as much as 33 percent ($2,050) lower than comparable U.S. costs.[1] After adjusting for transportation and tariff expenses, Japan has a 26.8 percent ($1,650) landed cost advantage over similar U.S. competition. Nearly all of the production-cost differentials can be linked to lower unit-labor costs in Japan (about $1,975 per subcompact). Roughly one-half of the labor-cost differential is attributed to lower hourly compensation of Japanese auto workers ($10.86 in Japan vs. $19.30 in the United States). The remainder results from greater Japanese labor productivity, or fewer labor hours worked per subcompact (80 hours per subcompact in Japan vs. 144 in the United States).[2]

1. See "Domestic Content Legislation and the U.S. Automobile Industry," Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, August 16, 1982, p. 30, table 5.

Import-Restriction Costs

In an environment where U.S. auto makers find it difficult to compete with foreign rivals in the subcompact market, U.S. auto workers and manufacturers are pleading for protection. Pushed by the United Auto Workers (UAW) and the Ford Motor Company, a "voluntary" annual limit of 1.68 million units on new passenger-car imports was secured from the Japanese for 1981 through 1983.[3] This quota allows domestic auto makers partial relief from Japanese competition and so protects the interest of U.S. auto workers. Like all protectionist strategies, quotas—voluntary or mandatory—raise the prices of imported goods. As consumer demand is forced toward domestically produced substitutes, the prices of protected goods will also rise. These price increases are analogous to a consumption tax, transferring income away from consumers to protected domestic producers. Like most taxes, this transfer reflects a political rather than an economic decision, inducing production inefficiencies and real economic loss. Over time, national resources are artificially allocated to less efficient producers from more efficient industries. Protectionist barriers further embody a perverse incentive system, allowing an industry to postpone making the production improvements that would be necessary in a more competitive environment. In effect, protectionism partially ensures that inefficient producers remain inefficient by reducing their incentives to do otherwise. The ultimate costs of these protectionist-induced inefficiencies are borne by U.S. consumers who must pay higher prices for protected products, laborers who lose employment opportunities in non-protected industries, and foreign producers who experience a profit loss.

2. Such estimates are subject to uncertainty, and the cost advantage may be overstated. Some analysts argue that the Japanese production-cost advantage is $800 to $1,000 per subcompact.

3. Not all imported cars are included in the voluntary import restrictions. Excluded are station wagons, vans, and miscellaneous transportation vehicles eventually destined for Puerto Rico.

Even with the declining demand for cars since 1979, the voluntary auto-import quotas appear to have been effective. These restrictions have prompted an increase in Japanese car prices. During the first year of voluntary quotas, the retail price of Japanese cars rose 25 percent above pre-quota levels.[4] Some of the price advance is in direct response to market shortages, as consumers bid up the price of available models. Volume limitations on imports of Japanese cars also prodded a shift toward imports of larger, more expensive Japanese cars. During the first six months of 1982, for example, the number of cars priced at $6,500 or less sold by the two largest Japanese auto manufacturers (Toyota and Nissan) declined 30 percent from the same period in 1981. The sales of Toyotas and Nissans priced between $6,500 and $11,000 increased 15 percent, while sales of Toyotas and Nissans priced higher than $11,000 rose 60 percent.[5]

In addition to model shifts, recent increases in Japanese car prices have resulted from "optional" equipment on Japanese imports. In the new-car market, optional equipment typically has higher markups (or margins) and is an important source of profit from new-car sales. Roughly 42 percent of all imported cars had factory-installed air conditioning in 1982, compared with only 28 percent in 1981. Imported cars with factory-installed cruise control increased from 9 percent to 31 percent over the same period.

Essentially, these quota-induced protection costs have been passed directly to U.S. consumers. Regardless, the Japanese have announced they no longer intend to honor voluntary restrictions beyond March 1984, demanding greater access to the U.S. car market.

4. See Kathleen Hamilton, "Quotas Take Toll on Japanese Importers, Dealers," *Automotive News*, July 5, 1982, p. 34. This price statistic includes favorable exchange-rate variations over the year.

5. See *International Letter*, Federal Reserve Bank of Chicago, No. 494, February 25, 1983.

Domestic-Content Myths

H.R. 1234, called the domestic-content bill, is the latest effort to protect the interests of the U.S. auto workers. The bill has cleared the House Commerce Committee and will soon be presented to Congress. The bill requires that a specific percentage of the wholesale value of each auto manufacturer's output be produced in the United States. This requirement would be applicable to any seller of automobiles with a U.S. sales volume of 100,000 units (or more) annually. The requirements would be graduated according to each foreign manufacturer's sales volume; when fully implemented, major new-car sellers would be required to produce 90 percent of a car's wholesale value in the United States. If enacted on schedule, only two importers, Toyota and Nissan, probably would be required to produce a full 90 percent of their cars' value in the United States by 1987. Honda, Mazda, and Subaru would also be subject to restrictive U.S. content obligations. Effectively, the bill would prevent large Japanese auto manufacturers from taking advantage of their lower production costs and would necessitate that the importers either relocate in the United States or radically limit their participation in the U.S. new-car market. In either case, altering the competitive structure of the car industry would generate price increases for new cars. The Japanese would lose the cost advantages from superior production efficiency, and greater demands would be placed on less efficient U.S. auto manufacturers.

U.S. legislators are far from unanimous in their support for the domestic-content bill, which originally sported 224 sponsors—testimony to its political appeal. Arguments regularly cited in defense of the bill often show misconceptions of international trade theory, as shown below.

We need legislation that would have the effect of requiring the Japanese to build plants and create jobs here where their major market is. A local content requirement is needed to preserve employment . . . .

DOUGLAS A. FRASER

Will domestic-content legislation, or any similar protectionist law, create jobs in the United States? Probably not; or, if so, not very many. Inasmuch as foreign producers would be forced to relocate production facilities to this country, or allow domestic auto makers a larger share of the U.S. market, the demand for auto workers would increase. So, too, would employment opportunities in industries closely related to auto manufacturing, such as rubber and electrical equipment industries. Unfortunately, this simple analysis fails to consider the consequences on employment in alternative, non-protected industries. Over time, protectionist-induced employment gains in the auto industry must come at the expense of job losses in non-auto-related industries as consumers devote a larger share of their limited incomes to auto expenditures and less to other goods and services. Job losses could be especially severe in export-related industries, such as computer manufacturing and farming. Attempts to turn the trade balance temporarily toward the United States risk a retaliation by a foreign government, in this case additional Japanese import restrictions on U.S. goods and services.

In theory, only the distribution of employment can be influenced by U.S. trade policies, leaving absolute employment levels unchanged, or trade neutral (allowing, of course, for the temporary reallocation of labor when trade patterns change.) A Congressional Budget Office (CBO) appraisal of the employment repercussions of the domestic-content bill bears this out. In a study prepared for the Subcommittee on Trade, the CBO estimates that, without Japanese trade retali-