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before the
Committee on
Commerce, Science, and Transportation

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Mr. Chairman, I am pleased to appear before your Committee today to discuss the proposed Fair Practices in Automotive Products Act, S. 707, and its counterpart (H.R. 1234) passed in the House during the last session. Both bills are designed explicitly to promote production by American workers by limiting the proportions of foreign-built components and materials used in automotive products sold or distributed in U.S. interstate commerce. In my remarks this morning, I would like to focus on three issues:

- How the U.S. auto industry has fared in the changed economic climate,
- How S. 707 would operate and how it would affect auto producers, and
- The economic consequences CBO sees arising from S. 707.

The Congressional Budget Office believes that, like its predecessors (S. 2300 and H.R. 5133) considered in the 97th Congress, S. 707 would stimulate employment in the domestic auto industry, but the costs to other sectors of the U.S. economy would outweigh these benefits. In general, CBO finds the net adverse economic effects arising from implementing S. 707 even more likely now than they were in late 1982, when CBO presented its evaluation of S. 2300 to this Committee. At that time, when the U.S. economy was in the trough of severe recession, with productive resources considerably underutilized, a reasonable argument--though a highly qualified one--could be made that trade quotas could generate short-run gains in employment. The significant risk of such policy initiatives, CBO noted, would be that the employment generated in one industry might be impossible to achieve without incurring employment losses in other industries.

As the economy is now in the midst of a strong expansion, there is less room today for the domestic auto industry to expand without diverting resources from other industries. Thus, the benefits to the auto industry are even more likely now--as the expansion matures--to be nearly or completely offset by higher costs to other industries.

THE AUTO INDUSTRY IN A SHIFTING ECONOMIC CLIMATE

Two years ago, the U.S. economy was experiencing the deepest economic trough since World War II, and the U.S. automotive industry--one of the economy's most cyclically vulnerable sectors--was in its worst decline in 40 years. The total industrial production index in 1982 was 5.1 percent below its 1978 level, while auto production in 1982 was some 44 percent below its 1978 unit output level. Total employment in motor vehicle and equipment manufacturing dropped from a peak of 1.05 million workers in January 1979 to 641,000 workers in November 1982--a decrease of nearly 40 percent. By the beginning of 1983, a record 269,000 auto workers were on indefinite layoff.

Effects of the Recent Upturn

The U.S. economy in general and the auto industry in particular have recovered dramatically from the 1981-1982 recession. Domestic auto sales in the first quarter of 1984 have returned to their 1979 levels, though they still stand 10 percent lower than the 1978 peak. As auto sales have

improved, many auto workers have been called back to work. According to figures of one trade publication (Wards Automotive Reports), the number of autoworkers indefinitely laid off had decreased to 97,000 by April of this year--a decline of 64 percent from January 1983. 1/ Figures issued by the Bureau of Labor Statistics (BLS) confirm this improved picture, showing an increase of 200,000 jobs in motor vehicles and equipment since late 1982. Recent reports of auto industry profits offer additional evidence that the industry is regaining its health.

U.S. automotive employment may not, however, achieve its 1978 peak levels, despite the strong economic expansion now under way. A slowing in the overall growth of the nation's automotive fleet, the introduction of more efficient plants and processes, together with a smaller proportion of larger cars than was produced in 1978, may ultimately mean that employment in the auto industry will not, in the near future, constitute the same share of total U.S. employment as in other recent expansions. U.S. auto firms, despite their growing competitiveness, are unlikely to recapture the market share they lost to foreign producers in the late 1970s. Increased "offshore

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1/ It should be noted that General Motors changed its method of reporting indefinite layoffs in 1983. Though this change makes comparison with the earlier layoff totals difficult, the total number of auto production workers recalled since January 1983 approaches the change in layoffs.

sourcing" of auto components, as domestic manufacturers attempt to remain cost competitive with foreign producers, will inevitably dampen employment growth in the auto-related industries.

THE MECHANICS OF S. 707 AND THEIR EFFECTS ON PRODUCERS

Like its predecessor bills, S. 707 would create additional U.S. auto industry jobs by instituting minimum "domestic content" requirements beginning with model year 1985. The provisions would be phased in, becoming fully operational by model year 1987. These content requirements (defined as U.S. value added as a percent of wholesale automobile price) would have to be met by every auto manufacturer, foreign or domestic, selling more than 100,000 units a year in the U.S. market. These requirements are graduated, from 10 percent to a maximum of 90 percent for all firms selling more than 900,000 vehicles. To assure compliance, vehicle manufacturers failing to meet content requirements would be subject to future restrictions on their volumes of sales in the United States, subject to a determination by the Secretary of Transportation.

Effects on Foreign Exporters

According to CBO's estimates, at least 15 percent of the wholesale value of an imported car would now qualify as constituting domestic content (most of this represents expenditures made by foreign manufacturers in the

United States for advertising, transportation, raw materials, and accessories.) The domestic content of foreign-produced autos could be increased by another 10 percent relatively easily by foreign automakers' purchasing additional U.S.-built components. Thus, domestic content of around 25 percent would be fairly easy for foreign automakers to achieve by 1990. According to the provisions of the bill, this would mean that each foreign auto producer could export 250,000 units per year to the United States without establishing production facilities in this country on a large scale. To maintain their U.S. market shares, however, the four large-volume Japanese auto producers--Toyota, Nissan, Honda, and Mazda--would have to locate a significant share of their production facilities in the United States. Honda and Mazda could probably meet the required domestic content levels without much difficulty. Honda already has production facilities in operation in Marysville, Ohio, and the domestic content required for Mazda would be only slightly above the easily achievable levels. The key uncertainty surrounds the responses of Toyota and Nissan.

Nissan has recently opened a light-truck manufacturing plant in Smyrna, Tennessee, and plans to produce cars there as well. Toyota has embarked on a joint venture with General Motors (GM) to manufacture cars at an idle GM facility in Fremont, California. But these facilities represent added production capacity, not substitutes for overseas production. Thus, Nissan and Toyota managers evidently do not yet think that shifting a

sizable proportion of their operation to the United States would provide any cost advantage.

Therefore, the practical effect of S. 707--at least in the short run--would be the imposition of an import quota on these producers.

Secondary Effects on the U.S. Industry

By restricting imports of passenger vehicles and light trucks, the domestic content requirement legislation would have a significant and direct effect on output and employment in the U.S. automotive and related industries. Under the assumptions that domestic sales of new cars do return to earlier trends and that all foreign auto producers (other than Toyota and Nissan) increase their sales volumes at rates that maintain their 1981 U.S. market shares, CBO's review of a number of analyses suggests that a reasonable estimate of S. 707's impact is a reduction of auto imports to the United States to about 2.6 million units by 1990--approximately 70 percent of the 3.75 million units that might otherwise have been imported in that year. By 1990, the displacement of 1.1 million foreign cars is estimated to force up vehicle prices by an average of about $333 per unit (in 1982 dollars). Higher auto prices, in turn, would dampen sales of automobiles. As a result, U.S.-built vehicle sales would rise by only 623,000 units--considerably fewer than the 1.1 million foreign cars displaced.

CBO ESTIMATES OF THE ECONOMIC EFFECTS OF S. 707

Most estimates presented in this testimony were made by CBO in late 1982, when the state of the economy and the auto industry was very different from today's. 2/ Nonetheless, these numbers can be considered a fair approximation of the economic effects S. 707 would produce. By 1990, as a consequence of S. 707, direct employment in auto manufacturing related to increased production would rise by about 38,000 jobs, and employment in auto-related industries would rise by some 69,000 more jobs than they would have otherwise.

The CBO's analysis implies, however, that despite the benefits in sales and employment to the U.S. automotive industry, the net effects for the U.S. economy--measured in terms of real economic growth, inflation, employment and consumers' welfare--would be negative. The costs borne by the rest of the economy would overwhelm the benefits accruing to the domestic automotive industry. In general, restrictive trade policies work to reduce U.S. national income, and the resultant smaller income is

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2/ See statement of Alice M. Rivlin, Director, Congressional Budget Office, before the House Subcommittee on Trade of the Committee on Ways and Means, September 23, 1982. See also Congressional Budget Office, "The Fair Practices in Automotive Products Act (H.R. 5133): An Economic Assessment," in U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Trade, Domestic Content Legislation and the U.S. Automotive Industry (August 16, 1982).

redistributed in favor of the beneficiaries of the restriction--in this case, the auto and auto-related industries.

Such legislation can affect the U.S. economy adversely for several reasons. It can reduce efficiency throughout the U.S. economy by artificially shifting resources from some sectors to others--in the case of S. 707, to auto production. This could drive up not only the prices of finished goods but also those of labor and capital inputs for all other industries. Furthermore, the closer the economy is to full capacity utilization, the stronger this effect is likely to be. Second, by restricting consumers' choice among types and models of cars, S. 707 would directly reduce consumers' welfare. Third, the reduction in world trade likely to ensue from the bill (even without foreign retaliation) would in turn dampen demand for U.S. exports, reducing output and employment in U.S. export industries. Finally --and particularly important--the proposed legislation could be expected to provoke retaliatory trade restrictions against U.S. export industries. Let me take up these points in some detail.

Loss of Efficiency

Two years ago, when CBO last presented its conclusions on the likely effects of proposed domestic content legislation, we suggested that whatever benefits might develop from the bill would probably be temporary

and would depend on the considerable slack--unemployment and low capacity utilization--then characterizing the economy as a whole. In a more fully employed economy, the overall effects of the legislation would be decidedly negative, with employment and output gains in the automotive sector attained only at the cost of attracting capital and labor away from other sectors of the economy.

Current economic conditions make this adverse outcome more likely for several reasons. First, because of diminished competition, U.S. car prices would be even more likely to rise in the face of present strong demand for automobiles and prolonged delivery lags. With the demand for automobiles as strong as it is today, if S. 707 were to reduce foreign competition in the U.S. market by a third, as suggested earlier, there is little reason to expect any strong incentive for moderation in sticker-price inflation.

Second, by artificially shifting productive resources from one sector to another (in this case, to auto production), domestic content legislation would tend to reduce efficiency throughout the economy. Particularly in the present expansionary phase--when competitive bidding for these resources is intensifying, especially among many expanding industries approaching capacity--such artificial shifting of resources would increase the costs of domestic production. This in turn would make U.S. consumers worse off.

Loss of Consumer Welfare

S. 707 stands to damage consumers' welfare with higher car prices and restricted freedom of choice. Some would-be buyers might actually respond by postponing a car purchase. Without making some simplifying assumptions about how consumers measure their individual, let alone collective, well-being, it is difficult to attach any exact dollar amount to this welfare loss. The auto industry has learned from experience, though, that consumers facing higher sticker prices for an automobile selection that does not meet their preference will tend to hold on to their old cars longer and/or purchase used ones that do suit their tastes. Ironically, by imposing progressively more stringent restrictions tied to the volume of sales, domestic content legislation would have its greatest impact on the high-volume auto producers apparently most responsive to American auto tastes and price preferences.

Repercussions in the World Economy

Though the economy as a whole is experiencing a vigorous expansion, the performance of the U.S. net export sector is lagging far behind. Much of the decline in the net export balance can be attributed to stronger recovery in the United States than abroad and to the continued increase in the value of the U.S. dollar, which makes U.S. export and import-competing goods and services more expensive in world markets. Many struggling export industries are hoping for some price-competitive relief in the form of

exchange rate depreciation and a stronger pick-up in foreign economic activity leading to stronger demand for U.S. exports.

By mandating a curtailment in auto imports, S. 707 could possibly cause foreign economic activity to expand less rapidly, in turn slowing the growth of foreign demand for all U.S. exports. In light of the importance of auto manufacturing to foreign economies--particularly to Japan's--and the nascent world economic recovery in general, these international repercussions on the U.S. economy seem likely unless foreign countries engage in offsetting expansionary policies. Furthermore, a reduction in U.S. auto imports could tend to strengthen the U.S. dollar on international exchange rate markets, raising the prices of--and lowering the demand for--the export products of U.S. firms. Moreover, this would give both auto and non-auto imports a further price advantage in American markets.

The most likely macroeconomic result is a net loss in U.S. employment and a slight decline in GNP. This would occur because employment losses in other industries would more than offset auto-industry gains. Nevertheless, the net changes would be small relative to the size of the economy. The main effect is a significant redistribution of real income from consumers and export industries toward the workers and shareholders involved in U.S. auto production.

Risk of Foreign Retaliation

The not unlikely response of the United States' trading partners to a restrictive policy such as S. 707 suggests another major area of risk. Foreign governments whose auto producers were injured by this legislation might have the right, under articles XI and XXIII of the General Agreement on Tariffs and Trade (GATT), to retaliate with dollar-for-dollar trade restrictions on U.S. exports. 3/ Even in the absence of GATT-sanctioned trade retaliation, protectionist legislation in general risks reigniting trade restrictions worldwide, which, past experience has shown, can have destructive effects not only on the U.S. economy but also on the world economy in general. The resultant reduction in world demand for U.S. exports would, of course, exacerbate any negative economic effect of the bill on the U.S. economy.

CONCLUSION

Though the enactment of S. 707 would increase the incomes and employment generated by U.S. auto production, CBO concludes that the

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3/ The domestic content bill considered in the last Congress, S. 2300, left open the question whether foreign governments whose auto producers were injured by the legislation would have such right under the GATT rules. The legislation adopted by the House, H.R. 1234, attempts to resolve this through a Congressional finding of auto-industry injury attributable to imports and a Congressional and Executive Branch fact-finding process aimed at determining whether the industry is still being hurt by imports six years from now, thus requiring maintaining H.R. 1234 as a solution to these problems. Analysts disagree about whether these elements of the legislation effectively foreclose the availability of GATT-sanctioned retaliatory actions against U.S. exports.

losses to be experienced by U.S. consumers and by the employees and owners of non-auto industries would outweigh the auto industry's gain. This would be true even if no retaliation against U.S. exports by foreign countries occurred; but if such retaliation did occur, the net loss would obviously be greater. There is the further danger of ever-increasing protectionism around the world, a trend that would run counter to the growth in world trade that has contributed so importantly to the long-term improvement in the living standards of the United States and its major trading partners.