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## SAVING THE STEEL INDUSTRY

### INTRODUCTION.

No industry appears to be in more dire need of help than steel. But as the recent confused debate over mergers and foreign imports has shown, there is little consensus about what should be done. Employment in the industry declined from 512,000 in 1974 to 245,000 in February 1984 as the steel slump continued.<sup>1</sup> This severe process of adjustment is particularly disturbing to many Americans because of steel's association with economic growth and well-being. How can the American economy prosper, they ask, when such a basic industry as steel is not strong, large, and healthy?

Many politicians have embraced the concept of a national industrial policy and import controls as the key to steel's improved competitiveness and "orderly" adjustment. Through a variety of federal programs, subsidies, tax credits, and trade restrictions, the proponents of industrial policy would seek to achieve target levels of output and employment (particularly in economically depressed regions), the retirement of excess steel-making capacity, and the modernization of remaining facilities.

Yet these advocates of industrial policy have largely ignored the reality of international trade in their proposals. They call for protectionist barriers, such as the steel import quota bill now being considered by Congress, or they seek relief under Sec. 201 of the Trade Act of 1974, the so-called escape clause. But international trade restrictions would harm both the competitive-

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<sup>1</sup> William T. Hogan, World Steel in the 80s: A Case of Survival (Lexington, Massachusetts: D.C. Heath, 1983), p. 119; American Metal Markets, April 18, 1984, p. 7. In January 1983 employment reached a low point of 229,600.

ness and the market structure of the American steel industry. Moreover, proper consideration of import barriers is relevant to any assessment of the competitive impact of mergers, as was shown in the recent LTV-Republic case.

A close relationship exists between industrial policy, trade policy, and competition policy in the steel industry. An examination of this relationship uncovers three major themes that should guide policy:

1. "Fair trade" protectionism in steel creates an incentive structure that actually prevents the industry from improving its competitiveness.
2. Restrictions on steel trade would invite protracted trade disputes and the disruption of international economic relations in general.
3. An industrial policy for steel would damage competition domestically and provide a framework for the progressive cartelization of steel markets world wide.

These conclusions lead to three important policy recommendations, which should form the basis of congressional action designed to save the steel industry. First, Congress should phase out quantitative trade restrictions and avoid creating new barriers. Second, industrial policies should be avoided, since they would delay or distort adjustment to international competition. And third, Justice Department decisions on steel mergers should be linked more closely to considerations of existing trade restrictions and their effect on domestic competition.

#### STEEL PROTECTIONISM AS AD HOC INDUSTRIAL POLICY

Industrial policy is essentially just another form of trade protection. In the case of steel, the goal is to maintain domestic production above the level that would occur in an open market--even if its final goal is a reduction in the size of the industry. This is achieved primarily through a variety of direct or indirect "temporary" subsidies.

Not surprisingly, many of the arguments used in support of protectionist trade policies in general are utilized by proponents of an industrial policy for steel: the need for a strong national industrial base, "breathing space" to facilitate adjustment, the prevention of economic turmoil in steelmaking communities, and the establishment of "fair trade."

#### The Challenge to the American Steel Industry

The declining international competitiveness of the American steel industry became apparent in 1959, when the U.S. became a net importer of steel. This decline was the result of fundamental

competitive factors. West European steel industries, for instance, had recovered from wartime destruction and begun to compete with U.S. steelmakers for American customers. Japan also emerged as a major steel exporter during the 1960s, and by the 1970s, was setting the standard for cost efficiency in world steel production.<sup>2</sup> In addition, American cost advantages in raw materials were eroding, particularly for iron ore and coking coal.

Rigidity and inflexibility in the American steel industry made it vulnerable to increases in foreign competition. The oligopolistic structure of the American steel market permitted price setting in times of depressed demand.<sup>3</sup> And as long as American steel producers enjoyed significant competitive advantages, imports could not penetrate the American market. But years of isolation from the world market left American steelmakers unprepared for the severe challenge of new and vigorous international competition.

The absence of serious competitive pressure had reduced the incentive to develop new steelmaking technologies.<sup>4</sup> An even more intractable problem, associated with the lack of competition, arose from the growing gap between productivity and wage rates (Table 1). The structure of the domestic market had allowed producers to agree to generous labor contract settlements by passing the increased costs along to consumers. But as imports increased their penetration of the U.S. market, these wage rigidities became a serious impediment.<sup>5</sup>

### Protectionism and the "Breathing Space" Theory

Adaptation to the new competition was deterred by the efforts of those who had a vested interest in the status quo. When imports surged in 1967 and 1968, the industry and the steelworkers' union launched a protectionist campaign. Heavy lobbying for protection in 1968 led to the first postwar "industrial policy" for steel: a three-year "voluntary" restraint agreement (VRA), under which producers in the European Economic Community (EEC)

<sup>2</sup> It is important to recognize that Japanese success in this and other areas was not dependent on government subsidies or industrial planning. See Katsuro Sakoh, "Industrial Policy: The Super Myth of Japan's Super Success," Asian Studies Center Background No. 3 (Washington, D.C.: The Heritage Foundation, 1983).

<sup>3</sup> See Federal Trade Commission, Staff Report on the United States Steel Industry and Its International Rivals: Trends and Factors Determining International Competitiveness (Washington, D.C.: U.S. Government Printing Office, 1977), pp. 157-170, and citations therein. An oligopolistic market is one effectively controlled by a handful of firms.

<sup>4</sup> Walter Adams and Joel Dirlam, "Big Steel Invention and Innovation," Quarterly Journal of Economics, May 1966, p. 169.

<sup>5</sup> See Kent Jones, "Impasse and Crisis in Steel Trade Policy," Thames Essay No. 35 (London: Trade Policy Research Centre, 1983), p. 40.

and Japan limited their steel shipments to the U.S. The agreement was renewed for another three years in 1971. The idea of the trade restriction was to provide a "breathing space" for the U.S. industry to close the capital expenditure gap that had contributed to its competitive decline in the 1960s. However, the incentive structure created by protection worked in exactly the opposite direction. By reducing competition it also reduced the pressure for adjustment. Capital expenditures actually declined through most of the VRA years, 1969-1974, while expenditures in competing countries rose rapidly (see Table 2).

The "breathing space" afforded by the VRA merely allowed the industry to avoid undertaking necessary restructuring. The labor costs of U.S. steelmakers continued to undermine competitiveness. By 1978, U.S. labor cost per net ton of steel shipped exceeded that of any other major steel supplying country (Table 3). From 1972 to 1977, hourly earnings of U.S. steelworkers increased 68 percent, while their output grew by only 3 percent--a gap much wider than the average for all manufactures (see Table 1).

The continued deterioration in American steelmaking competitiveness thus left the industry even more vulnerable than when steel demand collapsed in the mid-1970s. The oil price shock of 1973 and the ensuing worldwide recession, combined with increased steel production in Japan and the EEC, set the stage for radical price cutting on world steel export markets. Steel imports into the United States jumped to 17.4 million tons in 1977, a year that can only be described as one of "protectionist panic" in the U.S. industry.

Dissatisfied with the performance of the VRA agreements of the previous decade, U.S. steelmakers nonetheless sought relief from imports through trade laws and filed several antidumping suits in 1977. The protectionist campaign eventually resulted in the establishment of the Trigger Price Mechanism (TPM), which remained in effect for most of the period from March 1978 to January 1982. Aimed primarily at Japanese imports, it established import price guidelines based on Japanese production costs. If imports entered at prices below the TPM levels, an antidumping investigation automatically would be triggered. The protective effect of this system lay in the way it intimidated suppliers of low-priced foreign steel, who feared violating the trigger prices even if they could legitimately undersell them.<sup>6</sup>

Japanese steel exports to the U.S. did in fact decline as a result of the TPM. The U.S. industry then turned its efforts toward protection from EEC steel imports. This goal was achieved in October 1982 with an arrangement limiting EEC exports to the United States for a five-year period.

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<sup>6</sup> Ibid., pp. 40, 64-65.

Table 1

Percentage Increase of Average Hourly Earnings (current dollars)  
and in Output per hour of Labor Input, selected periods

	<u>Hourly earnings</u>		<u>Output per hour</u>	
	All workers <sup>a</sup>	Production workers	All workers <sup>a</sup>	Production workers
<b>All Manufactures<sup>b</sup></b>				
1955-1977	195	182	69	n.a. <sup>c</sup>
1957-1967	43	40	33	n.a.
1967-1972	35	35	16	n.a.
1972-1977	53	49	9	n.a.
<b>Steel and steel products<sup>d</sup></b>				
1957-1977	224	227	37	47
1957-1967	36	34	19	23
1967-1972	42	43	13	14
1972-1977	68	70	3	5

Source: Richard G. Anderson and Mordechai E. Kreinin, "Labour Costs in the American Steel and Auto Industry," The World Economy London, June 1982, p. 202. Calculations by the authors from data in United States Census of Manufactures for 1957, 1967, 1972 and 1977, Bureau of the Census, United States Department of Commerce, Washington, for hourly earnings; Handbook of Labor Statistics, Bureau of Labor Statistics, U.S. manufacturing; and Productivity Indexes for Selected Industries, Bureau of Labour Statistics, U.S. Department of Labor, Washington, 1979, for SIC 331 and 371.

- <sup>a</sup> Non-production workers are assumed to work the same annual hours as production workers.
- <sup>b</sup> Output originates from gross domestic product (GDP).
- <sup>c</sup> No index is available from the Bureau of Labor Statistics.
- <sup>d</sup> Standard Industrial Classification (SIC) 311; "output" is a physical production series constructed from the Bureau of Labor Statistics.

Table 2

**Capital Expenditures of Steel Industries in Selected  
Major Steel-producing Countries**

(in millions of dollars)<sup>a</sup>

Year	United States <sup>b</sup>	European Community <sup>c</sup>	United Kingdom	Canada	Japan
1965	1,823	932	139	141	510
1966	1,953	848	117	187	540
1967	2,146	730	136	114	843
1968	2,307	802	119	61	1,167
1969	2,047	1,005	102	95	1,494
1970	1,736	1,615	191	193	1,889
1971	1,425	2,310	414	236	2,607
1972	1,174	2,810	411	209	2,443
1973	1,400	3,033	401	215	2,039
1974	2,104	2,850 <sup>d</sup>	400 <sup>d</sup>	300 <sup>d</sup>	2,700 <sup>d</sup>

Source: Steel Industry Economics and Federal Income Tax Policy (Washington, D.C.: American Iron and Steel Institute, June 1975), p. 52.

a  
b  
c  
d

At official exchange rates.

Includes non-steel-producing activities of steel companies.

The European Community here refers to the original six member countries.

Estimated.

Table 3

Labor Productivity, Wages and Employment Costs per-Net Ton of Steel Shipped in the United States, West Germany, the United Kingdom and Japan, 1978

<u>Country</u>	<u>Manhours per Net Ton Shipped</u>	<u>Employment Cost per Hr. (\$)</u>	<u>Employment cost Net Ton Shipped (\$)</u>
United States	7.7	14.73	114.10
West Germany	9.4	11.43	107.35
United Kingdom	16.5	5.83	96.21
Japan	7.3	9.86	71.46

Source: New Strategy Required for Aiding Distressed Steel Industry. Report by the Comptroller-General of the United States (Washington, D.C.: U.S. Government Printing Office, 1979), p. 4.8.

#### Lessons of Protectionist Policy

This most recent steel crisis and its associated protectionist campaign illustrate the contrasting incentive structures of international competition vis-à-vis trade protectionism. Insofar as the increased world competition was allowed to penetrate the United States market, adjustment and increased competitiveness were encouraged--chiefly in the form of improved steelmaking technologies and the retirement of excess capacity. From 1977 to 1981, for instance, 12.5 million tons of steelmaking capacity were closed.<sup>7</sup>

On the other hand, efforts to aid the industry through trade restrictions have allowed many competitive disadvantages to persist. In 1977 and 1978, when protectionism was at its height, steel prices in the U.S. rose more rapidly than the indexes of consumer goods or industrial commodities. In 1976, 1979, and 1980, when import competition was more threatening, steel price rises were held at or below the average rate of inflation. Unfortunately for the industry, labor-management negotiations apparently internalized protectionism. Despite increased imports, for example, the union's settlement in 1980 included a pay increase that, given the comparative structure of steelmaking labor costs and productivity world wide, would probably have been impossible under freer trade.<sup>8</sup> The relatively minor cuts in pay and benefits

<sup>7</sup> Hogan, op. cit., pp. 93-123.

<sup>8</sup> See Wall Street Journal, May 28, 1980, p. 1.

accepted by the United Steelworkers in 1983 have done little to close the wage/productivity gap. In addition, plant closings and modernization by the steel companies have been delayed because the industry has been insulated from the brunt of international competition.

The failure of protectionism--or of any industrial policy--to aid an industry's competitiveness lies in the perverse incentive structures it creates. The very factors contributing to competitive decline--pricing practices and the wage-productivity gap in the case of steel--provide the motivation for a protectionist campaign, which in turn allows these factors to remain entrenched. Furthermore, the success of one protectionist campaign tends to lead not to restructuring, but to renewed pleas for trade restrictions. The TPM, for instance, led eventually to the steel arrangement with the EEC, which in turn has led to a call by the steel industry for comprehensive import quotas to cover all remaining foreign suppliers.<sup>9</sup> Removing the painful sting of competition subverts the objective of creating a healthy, robust steel industry. Adjustment cannot be spurred by a benevolent government bureaucracy; it must proceed in the marketplace.

## INDUSTRIAL POLICY AND THE "NEW PROTECTIONISM"

### The Dispute with the EEC

A protectionist industrial policy for steel would also encourage trade disputes and the deterioration of international economic relations. Evidence of this phenomenon can be found in the experience of the European Economic Community (EEC) and its industrial policy for steel. The record suggests that increased government involvement in planning, investment, and trade restrictions merely postpones and worsens the inevitable process of adjustment for the industry, and in addition, motivates suspicion and retaliation that easily lead to spiraling protectionism world wide.

When the world steel market collapsed in 1975, countries in the EEC were already burdened with overcapacity. In an attempt to soften the shock of sharply declining demand, the EEC Commission implemented policies of ever deeper government involvement and protectionism. The initial measures included voluntary "reference" prices and measures intended to restore "orderly" conditions to the European steel market. To prevent a disruption of its program by import competition, the Commission also concluded a "voluntary export restraint" (VER) agreement with Japan in 1975, similar in form to the U.S. VRAs eight years earlier.

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<sup>9</sup> The proposed Fair Trade in Steel Act and the petition for relief under Sec. 201 both call for a global import quota set at 15 percent (maximum) of domestic steel consumption. See American Metal Markets, March 2, 1982, p. 16, and January 25, 1984, p. 1.

As the steel crisis worsened, the EEC Commission sought to increase the scope of intervention. In 1976 it organized an EEC-wide steel producers' cartel, Eurofer, through which it could establish firm-by-firm production quotas and mandatory minimum prices. Typical of an industrial policy, the plan's purpose was to avoid extensive plant closings and layoffs, thereby providing a breathing space for reorganization.

According to the Commission's plan, export markets--particularly the lucrative U.S. market--would play a major role in the recovery of European steel. EEC representatives even began to talk of their "rightful" share of the U.S. market. And accordingly, EEC exports to the U.S. increased sharply. The U.S. International Trade Commission and Commerce Department concluded in 1982 that injurious dumping and subsidization had occurred, and were on the verge of imposing definitive duties, when the investigations were abruptly terminated by the five-year arrangement with the EEC limiting steel exports to the U.S.

### The Danger of "Rebound" Protectionism

Although the United States does not have an export-oriented steel industry, the introduction of an industrial policy for steel could lead to similar crises in trade relations. For instance, the General Agreement on Tariffs and Trade (GATT) provisions (article XVI and the Subsidies Code) note that countries can invoke rules for consultations and dispute settlement not only when state subsidies cause increases in exports that injure the importing country, but also when such subsidies cause reduction of imports to the subsidizing country, thus injuring the exporter. Industrial policies that displace imports to the large and lucrative U.S. market would be of serious concern to many steel exporting countries and could result in "rebound" protectionism.

Such rebound protectionism would not be new to the steel trade. It first appeared when the European Coal and Steel Community negotiated a VER agreement with Japan in 1971 in response to the American VRA of 1968, which had apparently diverted Japanese steel exports toward the EEC. And a long string of rebound effects can be traced to the 1975 VER agreement between the EEC and Japan, which apparently played a role in increasing Japanese exports to the U.S.--bringing about the subsequent antidumping suits and TPM policy. This, in turn, led to the EEC's basic price mechanism and new VER agreements in 1978. But increased EEC exports then led to the five-year steel quota agreement between the EEC and the U.S.--which again caused the EEC to tighten its system of VER agreements. The subsequent diversion of exports toward the United States has led to the current quota proposals.<sup>10</sup>

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<sup>10</sup> Jones, op. cit., pp. 21-25, 37-89.

The use of these new protectionist devices, therefore, is likely to be highly contagious. And aside from being contagious internationally, the demonstration effect of a successful plea for protection could prompt other industries to seek similar relief. Protectionist industrial policy, therefore, might prove an ideal catalyst for protracted trade disputes, along with a general deterioration in international economic relations and a decline in world and domestic economic welfare.

#### HOW INDUSTRIAL POLICY LEADS TO CARTELS

As the foregoing analysis shows, an industrial policy and its related trade restrictions are likely to hurt, not help, the process of adjustment in the steel industry. An equally serious conflict appears in the tendency of such policies to contradict the goals of competition policy. In the steel industry, the American policies of production controls and trade restrictions have actually forced foreign steel producers to engage in collusive activities. Although both the EEC and the United States have modified their laws to accommodate such activities (thereby eliminating an overt legal conflict), the objective of advancing general economic welfare through competition appears to have given way to an anticonsumer, cartel approach.

#### Why Cartels Fail

Any comprehensive government program to restructure the steel industry would probably require a cartel arrangement, including firm-by-firm production quotas and official pricing guidelines. Such measures are invariably utilized in a declining industry to reduce market supply, raise prices and profits, and spread the burden of capacity-reduction among firms. The EEC's steel cartel, Eurofer, has experienced the typical problems of any collusive arrangement: dissatisfaction and haggling among steel producers over their production quota allotments, dissension over official minimum prices, and failure to adhere to prescribed quota and price decisions. The U.S. would doubtless experience the same results if a comprehensive policy to "assist" steel were implemented.

Aside from the inherent problems and contradictions involved in a government's enforcement of cartel decisions, the efficacy and legitimacy of government-directed investment, production, and pricing decisions in the steel industry is questionable. Assuming that the industry must contract in order to become more competitive, which firms should contract and by how much? Competitive, market-driven adjustment mechanisms decide this automatically in a dispassionate manner based on efficiency criteria. An overall government policy of production cutbacks, however, would have to allocate such reduction to firms of varying size, product structure, and efficiency level. And it would be naive for anyone not to assume that local political conditions would be the overriding factor in many instances. It is impossible for any crisis cartel,

no matter what industry expertise is involved in its management, to restore competitiveness to an industry, when the very basis of competitive adjustment requires the market-driven allocation of resources..

### The Danger of Worldwide Cartels

The proliferation of voluntary export restraint (VER) agreements has also created a dangerous trend towards the cartelization of the entire world steel export market. This development will surely continue if the U.S. adopts an industrial policy for steel. The rebound effect of restrictive policies has encouraged the spread of collusive trade agreements to a large portion of the world steel export market. The most politically convenient method of reducing this rebound effect would be to include all steel importing and exporting countries in worldwide market-sharing agreements, similar to the multifiber agreement in textiles. Such a system would provide the structure for a world steel export cartel.

### NEEDED: A CONSUMERIST POLICY FOR STEEL

It is important to remember the anticonsumer nature of protectionist policies. Industrial policy calls for "cooperation" among domestic firms, implying higher steel prices. Controls on "disruptive" international trade lead to collusive behavior by foreign firms, again raising prices. And government-directed production and investment decisions under "burden-sharing" cartel arrangements mean resource misallocation, which taxes the economic growth of the country. An industrial policy for steel, therefore, must ultimately serve short-term producer interests to the detriment of consumers and the economy as a whole--and ultimately to the steel industry itself.

The salutary effect of international competition should be the unifying principle on which an effective U.S. steel policy is based. Restrictions on trade are inevitably counterproductive. Existing trade restrictions should be phased out and new barriers avoided in order to improve the performance and efficiency of the American industry. Consequently, industrial policies that would artificially increase prices and production above market levels, or otherwise distort market-driven adjustment to international competition, should be rejected. Such devices include subsidies, minimum prices, production quotas, and other collective "burden-sharing" arrangements.

Restructuring through mergers should be accompanied by trade liberalization in order to minimize market concentration. It should be remembered that exposure to international trade is perhaps the best antitrust device available to ensure competition in the steel industry. As the U.S. economy has become increasingly open to international competition, traditional measures of domestic market concentration have given way to a examination of

market shares held by foreign, as well as domestic, producers in dealing with antitrust issues.

The Justice Department's initial decision to block the merger of LTV and Republic was based on inadequate domestic competition due to trade restrictions.<sup>11</sup> Since the economic benefits of mergers, such as scale economies, can be effectively realized only in a competitive environment, trade liberalization in steel must go hand in hand with a policy of permitting mergers to facilitate reorganization and capacity reduction. Without substantial import competition, any restructuring of the U.S. steel industry based on mergers and acquisitions would invite inefficient and uncompetitive behavior by steel producers.

## CONCLUSION

The record of government intervention and protectionism in the steel industry provides a guide to the probable consequences of a national industrial policy for steel. The United States has had considerable experience with trade protectionism in steel, and such measures have only delayed adjustment in the industry, while inflicting higher prices on consumers and creating trade disputes. Yet trade restrictions and their damaging consequences would have to be intensified in order to provide the "breathing space" for the restructuring that industrial policy requires. And pleas for temporary protection invariably reappear, because the incentives implicit in protectionism actually work against the adjustment it is supposed to promote.

The record of government intervention in the EEC's steel industry provides more direct evidence of the failure of industrial policy. Neither the crisis cartel Eurofer nor its complex web of trade restrictions has managed to solve the industry's basic problem of overcapacity and reduced competitiveness. Instead, industrial policy has merely created a formula for internal disputes over burden sharing and international disputes with the United States over exports. Similar consequences would result if the United States adopted such policies.

The recent decision of the government of France to reverse its industrial policy for steel clearly illustrates the futility of resisting inexorable international market forces. After many years of subsidies, protectionist barriers, and other government policies that artificially kept inefficient steel plants in operation, French President Francois Mitterrand announced in April 1984 that 20 percent of French steelmaking capacity would be eliminated within the next year. American policymakers should heed the lesson in basic industrial economics evidently learned by the socialist President: "Either France is capable of facing

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<sup>11</sup> See American Metal Markets, February 16, 1984, p. 1.

up to international competition and prosperity, or it will be pulled down and head toward decline."<sup>12</sup>

If government policy is really to help the adjustment process, it should concentrate on measures to promote the needed redeployment of labor, such as job information services and retraining assistance. Trade problems based on instances of dumping and export subsidization should be resolved within the framework of trade laws and international negotiations designed to halt the violations, and not by reciprocal U.S. protectionism. Policies that move in this direction will begin to truly save the American steel industry by restoring international competitiveness in the U.S. steel industry and stability in U.S. commercial relations.

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<sup>12</sup> New York Times, April 5, 1984, p. 1.