

Protecting The Steel Industry For All The Wrong Reasons

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ABSTRACT. In the summer of 2002 President Bush made good on his campaign promise to steel workers. He enacted tariffs of up to 30% on 10 types of steel imports, claiming the U.S. steel industry was suffering from unfair trade practices by foreign firms. Were the integrated steel firms really harmed by foreign competition, or were there other reasons for the decline in the steel industry? Did President Bush have other motives when he placed tariffs on steel imports?

I. Introduction

The issue is not whether the steel safeguards are catastrophic for the U.S. economy; the conclusion is that the safeguards are unambiguously a drag on the U.S. Economy [Hufbauer and Goodrich, 2003b, 10].

In March of 2002 President George W. Bush made good on a campaign promise to the steel industry when he enacted steel tariffs of up to 30% on some types of steel. The justification given for the tariffs was to protect the integrated steel firms from unfair foreign competition. It was widely accepted by the American public that the steel industry was struggling to compete with its foreign competition; however this is not the case. The integrated steel firms have several other problems that are more important than foreign imports. Once you take a closer look at the steel industry you can see there was no economic justification for the steel tariffs. When President Bush enacted steel tariffs, he didn't do so to protect the steel industry from foreign imports. His motives were not near as noble as that. He did so for his own political gain.

II. Background

Over the last 30 years, protecting the steel industry has been the rule rather than the exception. Dan Ikenson put it best when he said, "It would be difficult to find another U.S. industry already more coddled and protected from the realities of the marketplace than the steel industry [2002, 1]." In the early part of this decade we again decided to protect

them. In 1999 and 2000 the steel industry was in the midst of a downward turn in the economic cycle. The industry as a whole had a net loss for 1999 and was well on its way to another loss in 2000. During the campaign of 2000 both Vice President Gore and Governor Bush were trying hard to get the important votes of the United Steel Workers of America in Ohio, Pennsylvania, and West Virginia. During his campaign for the presidency in 2000 President Bush promised steel workers that he would not forget them once he got to the White House. In the summer of 2001 he set in motion a series of events that would result in the enactment of section 201 tariffs on several types of steel imports. In June of 2001 President Bush, as well as the Senate Finance Committee, asked the United States International Trade Commission to conduct a safeguard study on 33 different types of steel imports. A safeguard study is a study to investigate if foreign imports are harming the domestic industry such that it needs trade protection. Five months later the ITC announced its findings; imports had a serious impact on 16 of 33 types investigated. Several types of steel were later merged into the same category, so in the end this number was reduced from 16 to 12. In March of 2002 President Bush ordered 10 of these 12 categories be protected with tariffs [Hufbauer and Goodrich, 2003b, 2].

III. Cost of Protection

Hot-rolled sheet steel is one of the most important steel categories protected. In 2002 the producer price index for this category increased about 30%, or \$80. Steel prices on the whole rose about 8.4% from the first to the third quarter of 2002 [Hufbauer and Goodrich, 2003a, 7]. While protection is not the only reason for the increase, it has contributed. Antidumping and countervailing investigations also contributed. The increase in manufacturing would also have an impact. But who ends up paying for the increase? Steel is a major input for several industries in the U.S. By protecting the steel industries others downstream are forced to pay more for their steel. The increase in the price of steel leads to an increase in the price of the final goods that have steel as an input. The bill for protecting the steel industry is ultimately paid by the final consumers of U.S. goods. In 1999 it was estimated that an increase of \$50 in the average price of steel would be a \$6 billion tax on Americans [Lindsay, Griswold, and Lukas, 1999, 7]. The exact impact on consumers is hard to find but there have been some estimates. Robert

Crandall estimates the cost to consumers in a different way; he says for each steel industry job saved, U.S consumers pay between \$800,000 and \$1.1 million [2002, 1] Hufbauer and Goodrich estimate it would cost more than \$400,000 per job saved [2003a, 2].

IV. Downstream Effects

Final consumers pay for the protection of the steel industry with the higher prices they pay for goods, but the industries downstream pay for the protection in jobs. Crandall estimates for each job saved in the steel industry as many as 13 could be lost downstream. If a 40% tariff is set on imported steel it could cause downstream industries to decrease output 1.5 to 4%. The reduction in output would cost up to 85,800 jobs. On the other hand the 40% tariff would only increase employment in the steel industry by roughly 6,400. If a smaller tariff of only 20% is enacted, steel using industries would lose up to 43,000 jobs while the steel industry would gain about 3,200 [2002, 3]. Along with the loss of jobs comes the explicit cost of additional unemployment payments to those who have lost their jobs, and possibly some additional welfare costs. While all of the numbers are just estimates, and all the steel imports are not subject to the tariffs, the trend is perfectly clear; the steel tariffs are hurting the industries downstream and raising prices for consumers.

V. The Proponents' Arguments

The steel industry and its supporters make several arguments to try to justify the trade protection they receive. The comments of Representative Phil English from Pennsylvania are an example of a common argument:

The domestic steel industry has been flooded by imported products pouring in from Asia, Russia and Latin America, swamping more efficient American producers and drowning thousands of jobs. This tsunami threatens to wash away a strategic industry that has been a keystone of our manufacturing sector for generations [Lindsey, Griswold and Lukas, 1999, 2].

If we take a closer look at this we can see several errors in Mr. English's argument. The first claim made by Mr. English is that the domestic steel industry is being flooded by imports. The World Trade

Organization's investigation of the U.S. steel tariffs found that the U.S. government failed to show that imports were increasing for five of the categories protected. Moreover, from 1999 to 2001 the amount of steel imported generally declined rather than increased [Hufbauer and Goodrich, 2003b, 3]. Also, import levels from 1997 to 1999 were roughly the same. The level of imports increased in the summer and fall of 1998 but fell again in the winter of 1998-1999. In February of 1999 imports were less than those from April of 1998 [Lindsey, Griswold and Lukas, 1999, 5]. It should also be noted that the steel industry itself imports large amounts of unfinished steel to work into finished steel products, Lindsey, Griswold and Lukas found that U.S. steel mills accounted for 20% of total steel imports in 1998 [1999, 2].

Mr. English also claims steel imports are costing American steel workers their jobs. However, protecting the steel industry will not necessarily save jobs. Increases in productivity have caused the steel industry to constantly downsize its work force over the last few decades. In 1980 it required 10 man hours to make one ton of steel; in 1999 it required less than four [Lindsey, Griswold and Lukas, 1999, 6]. From 1980 to 1998 the number of people employed in the steel industry declined by 60%. Also, the number of workers has declined in 16 of 18 years during the same time period [Lindsey, Griswold and Lukas, 1999, 6]. Moreover, from 1984 to 1992, the last time the United States imposed steel tariffs, employment in the industry fell by 78,300 jobs [Lindsey, Griswold, and Lukas, 1999, 2].

Proponents of steel protection also argue that the tariffs will allow the industry to consolidate and become more efficient. These proponents never really explain how the protection speeds up consolidation; they simply assert a relationship [Hufbauer and Goodrich, 2003b, 11]. These same proponents point out consolidation did occur while the tariffs were imposed. What the proponents fail to mention is every consolidation that has occurred in the steel industry since 1997 has happened because of bankruptcy [Hufbauer and Goodrich, 2003b, 11]. In this sense the tariffs are actually hurting the steel industry by propping up weaker companies and preventing the bankruptcy proceedings that lead to consolidation. By artificially inflating the price of steel, consolidation in the seven integrated firms is delayed. If the firms were to consolidate they could experience some economies of scale and decrease their average per unit cost. The steel tariffs are actually having the reverse effect proponents claim; they are slowing down consolidation in the industry. Even if the integrated

firms were using the protection to consolidate and increase efficiency it is not justification for protection. Other American firms and industries are able to consolidate and increase efficiency without the benefit of protection. The integrated steel firms should be held to the same standards.

The last argument made by proponents is that the steel tariffs will stabilize prices. The argument is flat untrue. The prices for steel products will still be able to fluctuate up or down on a daily basis just like before. The only difference will be that the fluctuations will be at a slightly higher price level. Or will they? Dr. Peter Morici, the former chief economist of the United States International Trade Commission says there is "no obvious correlation" between price changes and protection in the steel industry [2002, 2]. Dr. Morici cites examples of products that are protected, where the price rises only a small amount. He also cites examples of products that were not protected, where the price rises substantially. For example, Wide Flange Beams, a product not covered under the section 201 tariffs, saw its price increase by almost as much as many products that were covered [Morici, 2002, 3].

The steel industry has obviously been struggling in recent years. But steel tariffs are not the answer. For eight straight quarters from 2000-2002 the steel industry had an after tax net loss every quarter. The enactment of the section 201 steel tariffs helped the industry in the short term as both prices and capacity utilization rose. But negative effects in the industries downstream and in the steel industry in the long run far outweigh the temporary gains. President Bush's advisors must have known this from the beginning. All of the justifications were really just a smoke screen. The steel tariffs are not addressing the real problems facing the integrated steel firms. The tariffs only allow industry members to deny what is really happening. The American public would not be so willing to help the steel industry if they knew the truth; integrated steel firms are suffering from their own actions.

VI. Steel Industry Problems

The steel industry is struggling, but imports are not the main problem. The WTO found that the U.S. failed to show imports were the primary cause of injury to the steel industry. This was the correct finding; the steel industry has three other problems that it needs to deal with instead of worrying about competition from foreign companies.

The steel industry in the United States has too much capacity. Over the last twenty-one years steel capacity has gone through three phases: decline, constant, and increasing. From 1983 to 1987 American steel capacity declined about 25% and essentially remained at this level until 1994. From 1994 to 2000 mini-mills were increasing capacity faster than the larger integrated mills could get rid of it. Total capacity increased by 20%. The steel industry seems to have realized that in this case less is more and has begun to reduce capacity again [Hufbauer and Goodrich, 2003a, 11]. However, the decline could only be temporary. Some of the decline is due to the bankruptcy of LTV. When the bankruptcy proceedings are complete, capacity may go back up. While the U.S. International Trade Commission was conducting the safeguard study, capacity utilization was at its lowest level since January of 1987 [Hufbauer and Goodrich, 2003a, 12].

Protecting the steel industry puts the integrated firms in a no win situation. For the steel industry to be profitable prices have to be high, but high prices make it more profitable to produce steel. When it is more profitable to produce steel, the firms add additional capacity and increase production. The increase in production lowers the price. The steel industry provides a perfect real world example of this basic microeconomic principal. In 2001, eight flat-rolled mills were idled, because they were not profitable to operate, but once prices began to rise in 2002 and 2003 four of them were opened back up. These four mills increased total steel capacity by 10 million short tons, or roughly half of what was lost when the eight were idled. Also, in 1995 and 1998 the steel industry increased capacity after periods of rising steel prices [Hufbauer and Goodrich, 2003a, 11].

The second major problem facing the steel industry is its high legacy costs. Legacy costs are health care and pension obligations that integrated steel companies owe to their retirees. The legacy costs of the integrated firms are a two pronged evil in both costs and merger prospects. Bill Klinefelter estimated that these costs could have a net present value of more than \$13 billion when he testified before the House Subcommittee on Commerce, Trade, and Consumer Protection in 2002 [Hufbauer and Goodrich, 2003a, 12]. This \$13 billion could continue to grow. The rapid increase in pharmaceutical and other medical costs, coupled with the increasing life expectancy will not help the costs. The high costs place a financial strain on the industry. In 1999, health care costs for retirees were \$15 per ton of steel; pension benefits added \$50 more per ton. That

same year the seven integrated firms lost \$7 per ton of steel [Hufbauer and Goodrich, 2003a, 12]. In 2001 and 2002 the industry lost more money, and the legacy costs were even worse. Another way to look at these costs is as the percentage of sales. General Electric's legacy costs account for about 0.4% of their revenues. The steel industry's legacy costs account for about 2.8% of their revenues. The firm hit the hardest by legacy costs is Bethlehem Steel where they represented 20% of the cost of sales [Senate testimony, 2002, 8]. The legacy costs also make mergers less attractive since any company that acquires the firm will also acquire its legacy costs. It should also be noted that these legacy costs do not include any future environmental cleanup costs that the integrated firms could be forced to pay.

The third major problem faced by the integrated steel firm is the American minimill. There are several differences between minimills and integrated firms. First, minimills use mostly scrap metal melted in electric furnaces to make their steel products [Barnett and Crandall, 1986, vii]. Minimills also are often more specialized in their product lines than the integrated firms. Finally, minimills have fewer steps in their production processes than integrated firms. This process reduction allows them to be more efficient in their production [Barnett and Crandall, 1986, 4-11]. Competition from minimills is the main threat to integrated steel firms, not imports! From 1964 to 2001 the amount of finished steel imports increased 17 million short tons. While this might sound like a lot, it is less than half of the increase in minimill production over the same time period [Hufbauer and Goodrich, 2003a]. It should also be noted that not all of the 17 million short tons imported were finished steel. Remember that in 1998 integrated steel firms accounted for 20% of all steel imports [Lindsey, Griswold and Lukas, 1999, 2]. These minimills have a much better cost structure than their integrated competitors. Figure 1 shows the profit margins from both types of firms for 1995-2002 [Source: SEC, 2002]. These higher profit margins allow the minimills to make a profit in the down times when the integrated steel mills cannot. This can be seen most recently as the minimills still had a positive profit margin, while their integrated competitors did not.

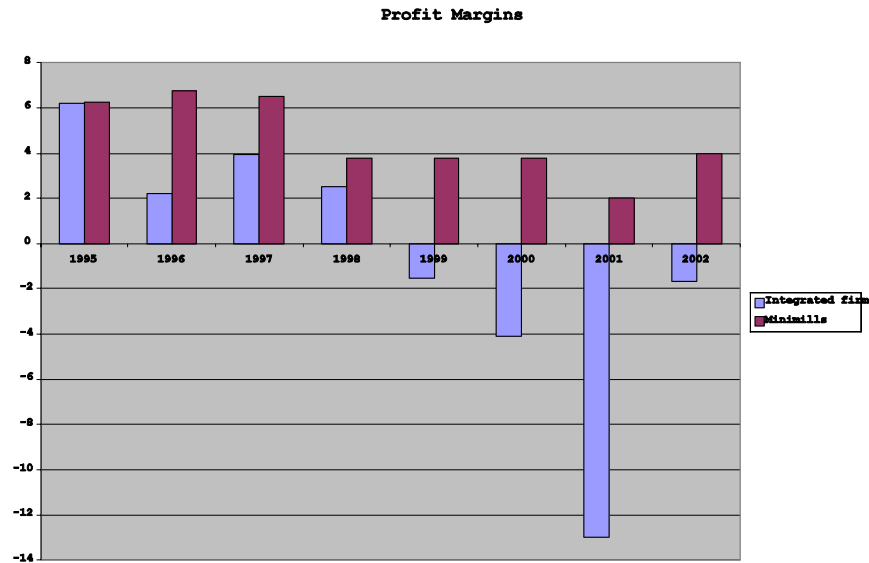


Figure 1

The real problem faced by the seven integrated steel firms is that they have been overprotected throughout the years. It is possible that the steel industry has been the most protected industry over the last 30 years. Every time protection is supposed to allow the industry time to modernize so it can compete with foreign firms. The steel industry is not using the protection to create lasting competitive advantages; it is using it for short term profit gains. If we continue to protect the industry there is no incentive for them to ever modernize. The firms, unions and industry organizations all know that the government will protect them again in the future.

VII. Political Reasons

It is apparent that President Bush did not enact the Section 201 tariffs with any economic justification. The WTO found the justification he tried to use to be wrong. If there was no economic justification then why did he impose the tariffs? President Bush enacted these tariffs for purely political reasons. In 1994, Grossman and Helpman developed a model that found the amount of trade protection for an industry to be a function

of the political contributions from that industry. Grossman and Helpman's model was originally designed to explain why governors treat some industries differently than others but I believe this model can also be used to explain the actions of a president. This model is a two stage non-cooperative game where the lobbies make their contributions in the first step and the government sets its trade policy in the second. The incumbent government is only concerned with two things, the total level of political contributions and aggregate well-being [Grossman and Helpman, 1994, 838]. Grossman and Helpman characterize political contributions "not so much as investments in the outcomes of elections, but more as a means to influence government policy" [1994, 848]. Taking these contributions in mind, as well as other factors, the government sets trade policy.

Even without considering Grossman and Helpman's model it is easy to see the political advantages to protecting the steel industry. Ohio, West Virginia and Pennsylvania were swing states in the 2000 presidential election. President Bush won West Virginia and Pennsylvania by a small majority, and lost Ohio by just as small a margin. If President Bush wanted to count on winning these states in 2004 he needed to keep the promises he made in 2000. Furthermore, the state most negatively affected by the tariffs was Michigan, with its strong dependence on the auto industry. President Bush was not going to win Michigan in 2000 and most likely will not in 2004. Tariffs would increase support for Bush in three states without significantly decreasing his support in other states. Figure 2 shows the vote totals for Bush and Gore for the states mentioned above.

	Ohio	Pennsylvania	West Virginia
Bush	2294167	2,264,309	329708
Gore	2117741	2,465,412	291088

Source: CNN.com/election/2000/results/

Figure 2

Another political benefit to President Bush is the passage of the Trade Promotion Authority. In 1998, the House of Representatives voted 243 to 180 against "fast-track"(the Trade Promotion Authority is the same thing with a different name). In 2001, the House passed the Trade

Promotion Authority by one vote. 31 members of the house changed their votes from no in 1998 to yes in 2001. Of these 31 votes, 10 came from members of the House Steel Caucus [Hufbauer and Goodrich 2003a, 3]. While there is no direct evidence of a deal between President Bush and the 10 who changed their votes, it appears too convenient to be purely a coincidence. Ironic, isn't it? Trade protection could lay the ground work for future free trade agreements.

In reality, nobody stood to gain more from the steel tariffs than the United States Government. The steel industry stood to gain little compared to the federal government. With the increased revenues from steel tariffs, the government expected to earn some \$650 million more from tariffs than the previous year. The numbers didn't quite meet expectations, but income from tariffs still rose \$294 million over the previous 12 months [Hufbauer and Goodrich, 2003b, 10]. The difference is possibly a result of two things. First, exceptions limited the number of products protected. Second, the policy makers underestimated the effect the tariffs would have on imports [Hufbauer and Goodrich, 2003b, 10].

VIII. Possible Remedies

In reality, there are any number of ways to "fix" the steel industry, but three seem to be the most reasonable. The government can step in and help with the overcapacity problem. The most common way for the government to do this is by buying capacity from the integrated firms. The major problem with this alternative is the incentive it creates for steel and other industries. How could the government be sure the firms wouldn't add more capacity after selling their outdated plants to the government? Also, if the industry has an overcapacity problem in the future will this set a precedent? How will the government respond to other industries that want the government to buy their excess capacity? All of these issues would be opened if the government buys some of the capacity from the steel industry.

The second idea is for the government to bailout some of the steel industry's legacy costs. On March 14, 2002 the Senate Committee on Health, Education, Labor, and Pensions had a hearing with steelworkers and leaders to discuss the legacy cost problem and what to do about it. In this hearing the committee mentioned a need to find a way for the government to solve the legacy cost problem [Senate testimony, 2002]. The former first lady, Senator Hilary Clinton went so far as to say "... I

don't think there is any alternative, Madam Chairwoman, but to address this legacy cost issue if we are serious about the industrial base of our nation..." [Senate Testimony, 2002, 21]. This option could cause even more problems than the first option. The steel industry is not the only industry or firm with high legacy costs. Companies like John Deere, Ford, GM, the entire mining industry and others all have high legacy costs. If the government were to takeover or partially bailout the steel industry's legacy costs each of the companies mentioned would be lining up to have their legacy costs paid. Another variation of this option would also be possible. The government frequently issues guaranteed loans to companies. This is what enabled Lee Iacocca to rebuild the Chrysler Corporation in the 1980's. The prospect of issuing guaranteed loans to firms that have demonstrated an inability to earn profits even in a good year is scary and risky.

The third option is a hybrid of the two previous ones. In this case the government would take over some of the steel industry legacy costs in exchange for the steel industry's reduction in capacity. This option, like the other two, would lead to other firms and industries asking for the same treatment. The government should not get involved in this mess at all. However, if one of these three options has to be chosen, the third is by far the best. With this option, an exchange occurs between the integrated steel firms and the government. The other two just involve the government bailing out the steel firms.

But in reality the best option is none of the three mentioned above. The best option is to do nothing. What the President and the rest of the government need to do is let the firms in the steel industry fight it out amongst themselves. This Darwinist survival of the fittest approach will allow the best firms to continue and succeed. The rest will either fail or be sold to the successful firms. If the firms were allowed to do this, the integrated firms would experience many benefits. The overcapacity issue would be solved. The problem with the minimills would also be lessened, since the remaining integrated firms would have a better cost structure. It is time the government puts its foot down and makes the steel industry survive in the world marketplace like every other industry in the United States!

IX. Conclusion

President Bush's decision to enact tariffs was flat wrong, and his justifications were not economic. The section 201 steel tariffs are only a temporary solution to a problem that is much bigger than foreign competition. In reality, foreign competition is not a major problem to the integrated firms. The steel industry needs to focus its energy on reducing its high costs. Until the industry is left unprotected for long periods of time, there will be no incentive to address the real issues. The industry knows that it can always ask for protection again. It will be hard to lessen the strain the legacy costs put on the industry. Bankruptcy may be the only option to reduce the costs.

The President enacted steel tariffs to protect himself. No one had more to gain from protecting the steel industry than the president and other government officials. The projected increase in government revenues would be the best thing to come out of the tariffs. It wasn't help to the integrated steel firms. Also, if President Bush were to not follow through on his campaign promise to the steel workers in 2000, he could lose support in 2004. Moreover, the president benefited from the lack of any immediate consequences for his actions. It took over a year for the World Trade Organization to rule against him. The passage of the Trade Promotion Authority which grants him the authority to negotiate future free trade agreements was also a major benefit. Some say economics is the study of trade-offs. To protect the steel industry President Bush made a trade-off; he put the welfare of the roughly 150,000 people employed in the steel industry, and himself, ahead of the welfare of the other 290 million of us.

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