SPECIAL COMMENTARY

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"Buy American" Legislation: An Economic Perspective

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Executive Summary

The economic stimulus measures making their way through Congress hit a speed bump this week over the "Buy American" clauses embedded in the legislation. In their original form, these provisions would have mandated only American-produced iron and steel could be used in government funded infrastructure projects. The aim of these "Buy American" laws is to increase the number of jobs in the iron and steel industry, an understandable goal in the current environment. But after President Obama expressed concern such policies could "trigger a trade war," the Senate conducted a voice vote to amend the provisions to be consistent with existing trade-agreements. In other words, they took the teeth out of it. So why are economists of all political persuasions coming out of the woodwork to voice their opposition to this legislation?

As economists are fond of saying, "there is no such thing as a free lunch." The mandate would likely increase the price of American-produced iron and steel at the expense of U.S. taxpayers. In addition, "Buy American" legislation could invite retaliation whereby foreign governments target some of America's most successful export industries for sanction. Jobs in the iron and steel industry could rise at the expense of employment in export industries.

We do not mean to disparage "Buy American" laws. Attempts to increase employment in the iron and steel, no matter how small the effect may be, may seem worthwhile in the current economic environment. Rather, our goal is to point out that there are costs, which may not be as readily apparent as the benefits, to the legislation. How an individual weighs the benefits and costs of "Buy American" legislation depends on his or her value judgments.

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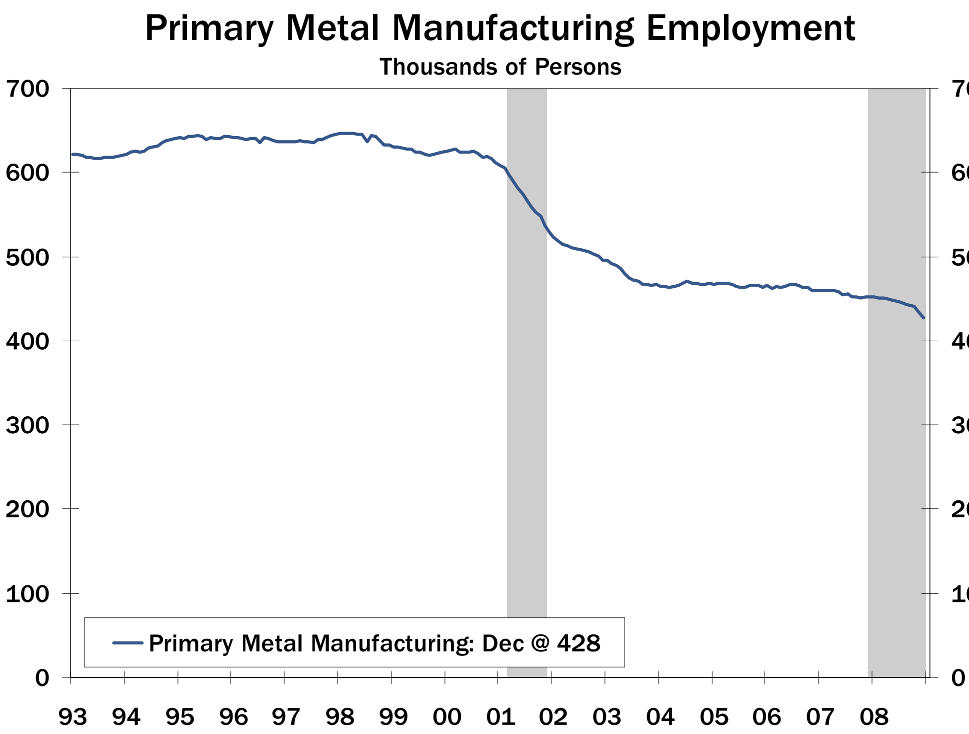
Goal of "Buy American" Laws is to Boost American Jobs

With the U.S. economy mired in its deepest recession in decades, policies that would end the layoff announcements that have become a staple of daily press reports have attracted the undivided attention of lawmakers. The stimulus package recently passed by the U.S. House of Representatives (HR1: American Recovery and Reinvestment Act of 2009) contained a provision that would require the federal government to purchase goods and services produced by American workers. Section 1110 of the bill stipulates that "none of the funds appropriated or otherwise made available by this Act may be used…unless all of the iron and steel used in the project is produced in the United States." The draft Senate bill (S336: American Recovery and Reinvestment Act of 2009) goes even further by stipulating that all "iron, steel, and *manufactured goods* (emphasis ours) used in the project" must be produced in the United States. These bills are commonly referred to as "Buy American" laws.

The number of workers in the iron and steel industry has declined more than a third since the late 1990s.

As noted above, the professed rationale behind the legislation was to employ more American workers, which seems like a sound policy in light of the fact that we are fast approaching roughly three million jobs that have been lost since the recession began in December 2007. In their original form, the bills currently in Congress would have aimed to boost employment in the iron and steel industry by mandating that all infrastructure projects use American-made iron and steel. As shown in Exhibit 1, the number of workers in the iron and steel industry has declined by more than a third since the late 1990s.[1] Surely, remedies to boost employment in the hard-hit iron and steel industry would be desirable.

Exhibit 1: Employment in the U.S. Primary Metal Industry



Source: Bureau of Labor Statistics

Winners? Producers of Steel. Losers? Users of Steel.

By mandating that the federal government buy only U.S.-made iron and steel in its infrastructure projects, "Buy American" legislation would clearly have been a boon

[1] "Primary metal manufacturing" is NAICS industry 331. The industry is broader than just iron and steel because it includes copper and aluminum foundries as well.

to American manufacturers of those goods. Although iron and steel are very capital-intensive, a few jobs might be created in the industry. Indeed, a recent study concluded that the employment effect is rather small – employment in the iron and steel industry would rise by roughly 1,000 jobs.[2] In the current environment, however, an increase in jobs, no matter how small, may be a victory. But as we mentioned in the summary, there is no free lunch. Are there costs to the "Buy American" laws that may not be as readily apparent as the benefits?

At one time, most of the iron and steel consumed in the United States was produced in the United States. For example, imports were equivalent to only 18.5 percent of total industry shipments in 1992. Today, that ratio is more than 40 percent. Why have imports flooded into the country? One reason may be that the quality of foreign-produced steel may be superior to the American variety. We are not experts on steel, so we are in no position to judge the validity of this quality hypothesis. As economists, however, we suspect that prices play an important role in explaining the rise in steel imports over the years. That is, the price of foreign-made steel probably has been and continues to be lower than the price of American-made steel.

The "loser" from a government mandate would be the U.S. taxpayer.

If U.S. government purchases of steel were switched from foreign producers to domestic producers by fiat, then the government would have ended up paying more for steel. Indeed, an increase in the demand for domestically-produced steel should raise its price further vis-à-vis foreign-produced steel. Therefore, the "loser" from a government mandate would be the U.S. taxpayer. Switching from foreign suppliers of iron and steel to domestic suppliers by legislative mandate would cause taxpayers to end up with less iron and steel (*i.e.*, less infrastructure) for a given amount of dollars spent.

Some observers may claim that foreign governments help their steel companies "dump" steel in this country. That is, government assistance reduces the production cost for foreign producers, thereby giving them an unfair advantage vis-à-vis their American competitors. Mandating that stimulus programs use American-produced iron and steel would be a means to redress the unfair advantage bestowed by foreign governments.

Whether or not foreign steel is actually dumped in this country is beyond the scope of this report. Lower prices for foreign steel may simply reflect lower production costs not foreign government assistance. But to the extent that it is dumped, the U.S. government should not ignore the infraction of international trade rules. However, there are channels to address this problem, namely the dispute resolution procedures of the World Trade Organization. "Buy American" legislation should not be used as a unilateral policy tool to address allegations of dumping. The measures could invite foreign governments to seek redress against American companies that are perceived to have an unfair trade advantage in those countries.

Retaliation Could Be Very Costly

The experience of the 1930s –- a decade that has been referenced countless times since the current financial storm began to rage in earnest -- shows how damaging retaliation can be. As the U.S. economy began to contract sharply, lawmakers passed the infamous Smoot-Hawley tariff in 1930 in an effort to protect American jobs. The

[2] Gary Clyde Hufbauer and Jeffrey Schott "Buy American: Bad for Jobs, Worse for Reputation" Peterson Institute for International Economics. Policy Brief #PB09-2 February 2009.

legislation raised U.S. tariffs on over 20,000 imported goods to record levels. In response, foreign governments raised their own tariffs against American goods. The Smoot-Hawley act was immensely unpopular in Canada, which at the time was the destination for roughly one fifth of all U.S. exports. In May 1930, Canada assessed duties on 16 products imported from the United States calling the retaliatory tariffs "countervailing duties". Just to remove any doubt about the catalyst for these measures, the duties -- which represented almost a third of the value of all U.S. merchandise exports to Canada –- were raised by the Canadians to match levels charged by the United States.

The effect of Smoot-Hawley on American exports was disastrous.

The effect on American exports was disastrous. Between 1929 and 1932, the volume of American exports plunged nearly 50 percent. Shipments of American goods to Europe were hit especially hard, freefalling from $2.3 billion in 1929 to $784 million in 1932.[3] Deep recessions in European countries surely weakened the demand for U.S. exports in the 1930s. However, the price competitiveness of American goods vis-à-vis their foreign counterparts was harmed by the foreign tariffs, thereby contributing to the collapse in U.S. exports in the 1930s.

Whether or not foreign governments would retaliate today via their own legislative actions is unknown. Moreover, the specific industries against which any retaliation would be directed is also open to question. Any retaliation, however, probably would be aimed at America's most successful export industries to make foreign displeasure with "Buy American" legislation painfully obvious to the United States.

For example, the aerospace industry is one of America's most important export industries, comprising more than seven percent of gross exports over the last two years. Over 500,000 workers are employed by the aerospace industry, compared with less than 435,000 on primary metal manufacturing payrolls. "Buy American" legislation could prop-up employment in the steel industry, but that could be offset by reductions in aerospace jobs.

Conclusion

The aim of the legislation was to boost employment at a time that such a boost is most-needed. Like all political decisions, there would be winners and losers if the legislation was enacted in its original form. Our aim in this report is to emphasize that there is no free lunch. Government legislation that seeks to introduce protectionism to boost domestic employment and orders in one industry may have unintended consequences in another. Barriers to trade have a tendency to spawn retaliatory tariffs abroad and hurt international trade. Smoot-Hawley began with the noblest of intentions, but has in the generations since become the epitome of the dangers and unintended perils of protectionism. Congress introduced this legislation with similarly noble intentions. Fortunately the collective voices of opposition were able to express the negative implications of protectionist policies and the Senate voted to take the teeth out of the "Buy American" provisions.

[3] U.S. Department of State, Under Secretary for Public Diplomacy and Public Affairs, Bureau of Public Affairs, Office of the Historian.

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