The Costs of a Protectionist Cure

by Michael F. Bryan and Owen F. Humpage

In recent years, many ailing U.S. industries have blamed their ill health on foreign competition and have sought a cure in limiting the flow of imports. While proponents of protectionist legislation argue that trade restrictions are necessary to protect U.S. jobs, economic theory indicates that protectionism may secure jobs at a substantial cost to consumers and economic efficiency. In capitalism, unlike in medicine, isolating the patient can cause the disease to spread. The Japanese Voluntary Export Restraint (VER) program, which restricts exports of Japanese cars to the United States, provides a useful example of such a costly cure.


The Auto Industry’s Malaise

Until the mid-1970s, sales of intermediate and full-sized cars dominated the U.S. auto market. Confronted with rapidly rising gasoline prices and economic recession, August 1979, many automakers altered their automobile preferences in favor of more economical, fuel-efficient models. By 1980, subcompacts represented the largest share of the U.S. new-car market—42 percent of the market with 31 percent in 1975 and 12 percent in 1965. Foreign producers, especially the Japanese, had an apparent advantage in the production of small, fuel-efficient cars and gained a substantial share of the U.S. new-car market during the 1970s. The Japanese share of the new-car market rose from 6 percent in 1972 to 12 percent in 1978. As the decade closed, domestic new-car sales contracted, falling 29 percent between 1978 and 1980. Sales of new Japanese cars, however, continued to expand, increasing about 21 percent of the market by 1980.

As declining domestic car sales idled U.S. labor and capped the United Auto Workers (UAW) and some of the large domestic car producers aggressively sought protection from their foreign competitors, especially the Japanese auto-makers. In June 1980, the UAW petitioned the International Trade Commission (ITC), alleging that imports were a substantial cause of serious injury to the domestic industry and seeking both higher tariffs and quantity restrictions against car imports. Ford Motor Company filed a similar petition in August 1980. The ITC, however, rejected the petitions. Failing to enlist the ITC’s support, lobbyists aimed their efforts more directly toward the Japanese government. Both the Carter and the Reagan administrations approved neither legislated quotas nor tariffs, encouraged the Japanese to limit voluntarily their new-car exports to the United States. In May 1981, the Japanese government finally agreed to “voluntary” limits on their car shipments to the United States.

Japan’s initial agreement to limit car exports extended from April 1981 through March 1984; in November 1983, the Japanese government extended the agreement through March 1985. During its first three years, the agreement limited Japanese car exports to the United States to 1.68 million units, contrasting with sales of 1.91 million units in 1980 and 1.76 million units in 1979. Under the current fourth-year extension of the program, the limitations on Japanese new-car exports have increased to 1.85 million units.

VER Side Effects

By limiting the flow of new Japanese cars into the United States, the VER program creates an artificial scarcity that drives up new-car prices. As the prices of new Japanese cars rise, some potential buyers will purchase new domestic cars, other imported cars, or used cars, thus placing upward pressure on the prices of these vehicles. Because of the VERs, consumers now purchase fewer cars in total.
and pay more for them. Economists can measure this loss and refer to it as a reduction in consumers’ surplus.

The reduction in consumers’ surplus comes in two parts: one is the increase in the price of Japanese car components, and the other is the increase in the price of the Japanese car itself. The component cost increase flows through to the price of Japanese cars, boosting their price by $51. Unit sales fell 78,000 during the VERs’ second year, and 3.4 million units in 1983 (see table 1).

The total three-year loss in consumers’ surplus resulting from the VER-induced increase in Japanese new-car prices is approximately $7 billion. Most of this loss occurred in 1983, when the program was most binding on the U.S. market. Of this total amount, $2.5 billion was due to the transfer of purchasing power to dealers and Japanese producers of cars who continued to buy Japanese cars at the higher VER prices. Approximately 80 percent of this income transfer accrued to U.S. dealers of Japanese cars and 20 percent to Japanese producers. Japanese producers received the remaining $400 million. Of the total reduction in consumers’ surplus, the largest component—$1.77 billion—is due to increased inefficiencies and foregone opportunities, as the VER program increased the wholesale price of new Japanese cars by $1,114. Again, we refer to increased inefficiencies as the failure of U.S. consumers to buy US. imports or invest in US. assets, such transactions could take place only in the long run, the United States, especially in the short run. Although most of the income transferred from U.S. consumers to Japanese producers eventually returns to the United States as foreigners buy US. exports or invest in US. assets, such transactions could take place only in the long run.

The results of the model simulations (shown in table 1), including the costs of VERs, are consistent with previous studies of the effects of VERs. Consumers’ surplus declines in response to price increases. The income transferred to foreign producers, however, does not represent a net loss to the United States, especially in the short run. Although most of the income transferred from U.S. consumers to Japanese producers eventually returns to the United States as foreigners buy US. exports or invest in US. assets, such transactions could take place only in the long run.

We estimated the proprietary income transfers from US. consumers to Japanese producers resulting from VERs. As we refer to increased inefficiencies as the failure of U.S. consumers to buy US. imports or invest in US. assets, such transactions could take place only in the long run.

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Cost of the Treatment

We constructed an econometric model of the U.S. market for new Japanese cars to measure the price and quantity impact of the VER program. In building the model, we wanted to incorporate the role of new-car dealers and inventories in the market-clearing process. VERs restrict imports, but sales can be accommodated from inventories over the near term. The existence of inventories dampens the effects of VERs, causing our measures of income transfers and efficiency losses did not include those associated with reducing dealer inventories for other cars sold in the United States; consequently, they understate the total cost of the VER program.

According to the results of the model simulation (shown in table 1), during the first year of the VERs, there was virtually no net price pressure in the Japanese new-car market. The options-adjusted transactions price of new Japanese cars increased $11 per unit because of the VERs, primarily reflecting a rise in wholesale prices. Dealers did not increase their markups, as they experienced an overstocked inventory position prior to the VER program that lasted halfway through the program's first year. The effect of VERs was to lower sales by only 4,000 units during the first year, a negligible amount for a market of 1.8 million units.

The next year, declining quarterly data from 1976 through 1983. In many ways, our results were similar to previous studies of the new-car market. We found that real permanent income is the primary determinant of new-car sales and that sales of new Japanese cars rise with operating costs (gasoline, insurance, and repairs). We also found a price elasticity for new Japanese cars of 1.3, which is nearly identical to a 1.3 (comfort and aesthetic appeal) that their cars can provide. Foreign producers will tend to upgrade the unrestricted aspects of the product in an attempt to maintain their profits. When measuring the effects of the VER in Japan, one should exclude price increases attributable solely to quality improvements, as these do not reduce consumers' economic well-being.

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autoworker employment would have fallen by 600 workers. The total loss in consumers' surplus in this case equaled $314 million. Gomez-Ibanez, Leone, and O'Connell constructed an annual model of the U.S. automobile market to measure the effects of the VERs that did not include a quality-adjustment allowance or an inventory influence. Instead, they divided the U.S. market into basic small cars (Japanese and all others), luxury small cars (Japanese and all others), and traditional cars. The researchers simulated their model, which was not specific to a particular year, under alternative assumptions about the new-car market and different price/quantity reactions to the VER program from domestic car producers. In the case that most resembled actual 1981 and 1982 market conditions, the VER program raised Japanese new-car prices 2.6 percent and reduced Japanese new-car sales in the United States 6.7 percent per year. U.S. car production rose 0.5 percent, and U.S. autoworker employment increased 6,500 workers. Gomez-Ibanez, Leone, and O'Connell estimated that the loss to consumers in all segments of the market associated with their model simulation was $566 million per year.


Economics Research Center

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The VER program is an expensive way to treat the auto industry's malaise.

The Effects of Japanese Voluntary Export Restraint

As declining domestic car sales idled U.S. labor and capped domestic workers, the United Auto Workers (UAW) and some of the large domestic car producers aggressively sought protection from their foreign competitors, especially the Japanese automobile makers. In June 1980, the UAW petitioned the International Trade Commission (ITC), alleging that imports were a substantial cause of serious injury to the domestic industries and seeking both higher tariffs and quantity restrictions against car imports. Ford Motor Company filed a similar petition in August 1980. The ITC, however, rejected the petitions. Failing to enlist the ITC's support, lobbyists aimed their efforts more directly toward the Japanese government.

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