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TARIFFS AND THE OBJECTIVES OF POLITICAL LEADERSHIP

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Prologue

In today's world of political economics, the topic of international trade is only large enough to accommodate two points of view: one that believes in free trade and one that believes in protectionist policies. You're either in one group or the other.

Both pure trade and international finance are vast fields of economics incorporating the highest levels of competence, formal theoretical skills and math. Any bimodal classification of people's views and thoughts is grotesquely misleading. Trade theory and its practice is as nuanced as any branch of economics—full of rich, deep theory and empirical research. Treating the topic loosely or superficially is dangerous in the extreme. Let the reader beware. Enter at your own risk.

Trade Policies in Today's America

It is springtime for tariffs in America. President Donald J. Trump has regularly been imposing them, or threatening to impose them, on products imported to the United States from China, Mexico, Canada, and other nations of distinct economic and geostrategic significance to the United States. The President's moves are consistent with his rhetoric from the 2016 election. Candidate Trump talked about tariffs repeatedly and won the election, so now we are getting them. But what are we to make of these recent trade policies?

For decades following World War II, tariffs and other trade barriers, as seen by Americans, seemed to be destined for the dustbin of history. Economists of all stripes, especially here in the United States, attacked tariffs mercilessly as they extolled the benefits of free trade. In the global policy realm, major international organizations, such as the General Agreements on Tariffs and Trade (GATT) and the World Trade Organization (WTO), made it their mission to lessen tariffs to the point of elimination. In the popular mind, the connection between free trade and economic growth, overall prosperity and a rising stock market (and thus retirement accounts) took hold. Professor Milton Friedman pointed with professional pride to the near unanimous support of free trade among economists, saying that their uniformity of opinion on this issue was an exception to the jibe that 'for every two economists, you get three opinions.'[2]

The benefits of free trade are based on classic comparative advantage trade theory, as originally espoused by the English economist David Ricardo. Consumers, producers and economic growth all benefit on average from free trade. The winners from free trade outweigh the losers. Without making interpersonal comparisons, the logic of other economists was that the losers from free trade could be subsidized at the expense of the winners from free trade and that there would still be gains left over. Such a scheme is superficial on its face and not very practical. Thus, save for within special-interest lobbying groups, free trade has become consensus thinking.[3]

However, practical countercurrents continued to run underneath the consensus on the principles of free trade. The United States government-imposed tariffs, or at least threatened to, continually throughout the post-World War II period. For example, in the 1960s, President Kennedy adopted the interest equalization tax to block international capital flows and President Lyndon Johnson placed tariffs on European-made trucks. In the 1970s, President Richard Nixon instituted an across-the-board 10% import "surcharge" (or tariff); President Gerald Ford made "a proclamation on oil-import tariffs" that included new oil-import fees; and President Jimmy Carter proposed the closing of foreign-oil tax "loopholes." Attempts to achieve energy independence by way of tariffs and buy-American policies have been a regular feature of political-economic rhetoric since World War II.[4]

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[2] Milton Friedman, "Free Trade: Producer Versus Consumer," Landon Lecture, April 27, 1978, https://www.k-state.edu/landon/speakers/milton-friedman/transcript.html.

[3] Arthur B. Laffer and Julia Roseman, "Trade Protectionism," Laffer Associates, July 28, 2016.

[4] Gerald R. Ford, "Remarks of the President Upon Signing a Proclamation on Oil Import Tariffs," Public Papers of the Presidents, Jan. 22, 1975.

In the 1980s, President Ronald Reagan ordered a tariff substitute in the form of quotas on Japanese cars. And in the 2000s, President George W. Bush put tariffs on steel imports. These are prominent examples of specific tariffs by U.S. administrations in recent years, but they are not all-encompassing.

In politics, there were several overtly protectionist presidential candidates, including Rep. Richard Gephardt (D-MO) in 1988; Republican and Reform Party candidate Patrick Buchanan in the 1990s and 2000s; and H. Ross Perot, who got millions of votes for president in 1992 and in 1996. Perot's tagline was the "giant sucking sound" coming out of Mexico, which implied that free trade was sending American jobs to cheap-labor foreign countries and that tariffs were necessary to fix these "job losses." In the 2000s, labels saying "made in China" increasingly appeared on so many consumer goods Americans encountered at the store and online, stoking the populist sentiment that Donald Trump exploited in the 2016 election. The appeal of protectionist policies grows during hard times. Losers need excuses, and what better excuse is there than that foreigners are stealing our jobs?

The discussion of the Trump tariffs has been characterized by extremes since May 2017, when the President first made clear that he was going to pursue them vigorously. As a result of tariffs being the *choix du jour* of President Trump, economists have doubled-down on the virtues of free trade, contending that tariffs are unacceptable in any and all cases. Commentators in favor of the Trump tariffs (such as the aforementioned Patrick Buchanan) have argued that the United States has a rich tariff history and that tariffs are necessary to "Make America Great Again."

A recent article of Buchanan's hails the virtues of U.S. tariff history.[5] In so doing, the article reveals a good deal about the attractiveness and political constituencies of tariffs in America today—and the dangers in waving off any mention of tariffs, a peremptoriness to which economists have made themselves prone. Buchanan gave his article the Trumpian title, "Tariffs: The Taxes That Made America Great." It draws the undeniable historical parallel—which economists must be careful not to gainsay—that the United States economy grew fantastically well when the tariff duties "were the taxes relied upon by the first and greatest of our early statesmen." Buchanan cited the phenomenal productivity of the American economy in the nineteenth century, when the tariff was the dominant, often exclusive, means of federal taxation. He asked with relevance: "What great nation did free-traders ever build?"

What has been missing from the current debate is a clear-eyed objective assessment of tariffs—free from prior commitments to either free trade, or to protectionism, or to Trumpism. It would do us well to inquire, as objectively as we can, after what are the economic—and perhaps even the political—costs and benefits that accrue from tariffs. The benefits of free trade are well-known.

<u>Defining Tariffs</u>
A tariff is, after all, only a tax on imported goods. Other restrictive trade measures include quotas, embargoes, currency manipulation, and non-tariff barriers. A sanction or an embargo is a specific prohibition on trade, or what could be called an infinite tariff. Technically, a tariff is a set of taxes on imported goods. This set comprises the duties prescribed under one law on various items brought into a country to be offered for sale. In being a tax, like any other tax, a tariff has no *prima facie* reason to be excluded from consideration when the topic is how best to construct a tax and fiscal regime for a country.

Free trade, i.e. no tariffs or non-tariff barriers, implies that governments must rely exclusively on other forms of taxation, namely those imposed on the domestic population—income, sales, excise taxes and the like. The questions to ask are: are these domestic forms of taxation better forms of taxation than a tariff? And, if not, then under what conditions would a tariff or sanction be preferable? This is a question that must be submitted to the rigors of political-economic analysis.

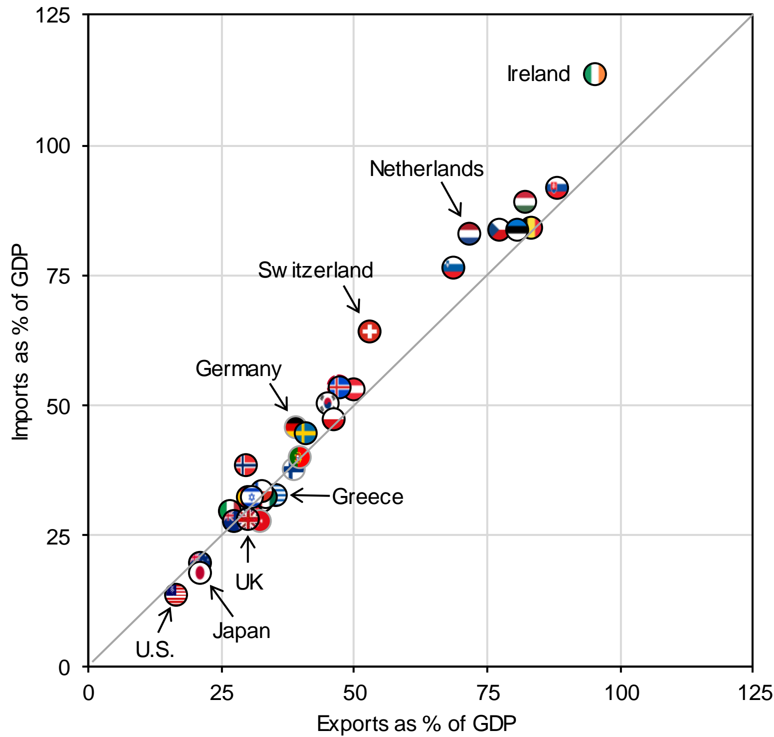
Trade theory has plenty to say about tariffs, quotas and other trade impediments. We'll discuss some of the principles later in this paper, but a summary of a few principles and definitions seems in order here:

- Exports minus imports is the trade balance—a negative number constitutes a trade deficit and a positive number constitutes a trade surplus.
- When exports of goods and services exceed imports of goods and services, this is also called a current account surplus as the trade balance is the largest part of the current account.
- The trade, or current account, surplus (deficit) is, by accounting definition, the capital account deficit (surplus).
- U.S. exports also, by definition, are foreign imports and foreign exports are U.S. imports. The U.S. trade deficit is one and the same as the foreign trade surplus, etc.

[5] In re Pat Buchanan, one of the authors was touring Washington, D.C. with his wife and two blonde toddlers in a double stroller when none other than Pat Buchanan ambled out of a building, only to praise the co-author for having such a lovely blonde family. He was quick to note that America needs more such families. Patrick J. Buchanan, "Tariffs: The Taxes That Made America Great," May 13, 2019, https://buchanan.org/blog/tariffs-the-taxes-that-made-america-great-136986.

- A country's exchange rate is the foreign currency price of the domestic currency—i.e. the U.S. dollar/UK pound exchange rate is the number of UK pounds per U.S. dollar.
- A country's terms of trade is the price-level-adjusted exchange rate, e.g. what's the relative price of U.S. goods measured in terms of UK goods.
- The exchange rate and the terms of trade are frequently and erroneously used interchangeably, especially by Ph.D. economists.
- A tariff drives a wedge between the price of U.S. and UK goods, making U.S. export goods more expensive in the UK and UK export goods more expensive in the U.S., all the while making U.S. export goods less expensive in the U.S. and UK export goods less expensive in the UK.
- As such a tariff, whether imposed by either country, hurts both domestic and foreign consumers of imports and foreign and domestic producers of exports: this is Lerner's Symmetry Theorem. A tariff on imports is conceptually the same as a tax on exports.
- The tariff-imposing country collects the revenues.
- Just as people earn income to buy goods and invest, so too a country exports goods in order to earn the wherewithal to buy imports. Thus, a tariff on imports has the exact same effect as a tax does on exports. (see Figure 1)

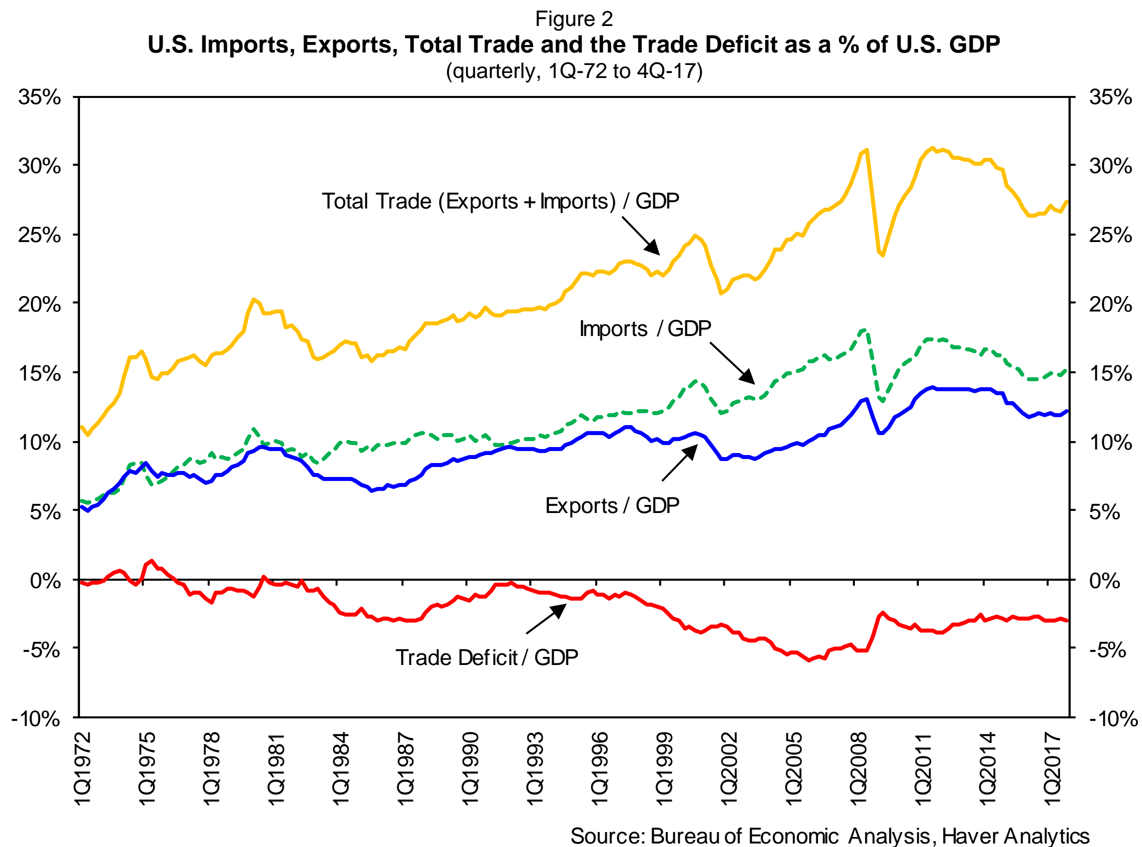
Figure 1
Trade in OECD Countries: Imports and Exports as a Share of GDP
(annual, 2016)



Note: Luxembourg is excluded.

Source: OECD

Figure 2 is a plot of U.S. exports, U.S. imports, total trade, and the U.S. trade deficit, each as a share of U.S. GDP.



Tariff History to 1913

The first half of the taxation history of the United States was largely tariff history. The first law of any consequence passed by Congress was the Tariff Act of July 4, 1789. For one 44-year stretch, from 1817-1861, tariffs were the only form of federal taxation. For five decades after that, until 1913, the tariff was the dominant form of taxation, with the excise tax on alcohol coming in a distant second.

Politically, the tariff was the leitmotif of the American republic over the first half of its history, from 1789 to 1913. Domestic taxation largely went by the boards with the Pennsylvania Whiskey Rebellion in the 1790s, when revenue agents who had come to collect alcohol sales taxes were tarred and feathered. Thereafter, Congress felt it was easier—and safer—to rely on a tax that foreign merchants knew they would pay at the United States customs house when they disembarked with their cargo from a distant shore.

Nonetheless, whenever the tariff list got long and its duty rates high, as in the tariff of "Abominations" in 1828—domestic unease still came. That tariff brought about the nullification crisis of 1832-1833, in which South Carolina declared it would void the federal tariff law in its own ports. South Carolina stood down after the federal government prepared to use force against it, but the damage to the cohesiveness of the Union was already done. The garrison the United States was building in the state's main harbor, Charleston, was Fort Sumter. Three decades later, in 1861, South Carolinians would gleefully shell and capture it to begin the Civil War. A saying goes that when goods cannot cross borders, troops will. The civil war showed that when goods cannot come into a country, troops will menace within it.

After 1865, it became almost a violation of the cause of the victorious union to seek to diminish the tariff. The South had hated the tariff, and the South had now been beaten. Union piety required that the tariff had to stay, preferably at high levels, as a testament to the sacrifices made in putting down the late rebellion. With average duty rates past 50%, and a list running into the dozens of pages, the Gilded Age tariff eventually alienated majorities in the North. As the twentieth century began, a movement was afoot to lessen it by means of a compensating income tax.

In 1895, the Supreme Court invalidated an income tax passed by Congress because that tax had not respected the complicated requirements for "direct" taxation of the population set forth in the Constitution. Any tax required of an inhabitant individual, per the Constitution, had to be assessed according to each state's share in the national population. If New York had 1/15th of the population, it would be responsible for that proportion of any national income tax, with rates within that state set accordingly.

This Constitutional machinery proved too difficult to permit a passage of an income tax that might lessen the need for the tariff. Therefore, a campaign began to amend the Constitution to permit any kind of federal income tax. This campaign culminated in the 16th Amendment to the Constitution, which gained ratification when the 36th state (Delaware) approved it in February 1913. At every turn in the campaign for this amendment, its supporters pointed out how an income tax would enable Congress to cut the tariff. One legislator called it "a club to beat down high protective tariff rates."[6]

In October 1913, in one piece of legislation, the Revenue Act of 1913, Congress cut the tariff by a third and introduced the nation's first permanent income tax. That tax proved that it had indeed been a club to beat down the tariff. As the law put in place a progressive income tax on high earners ranging from 1% to 7%, tariff rates were lowered from an average level of about 40% to just over 25%.[7]

The chief sponsor of the bill (which was signed into law by President Woodrow Wilson), was Democratic Rep. Oscar Underwood of Alabama. The bill is often referred to as the "Underwood Tariff." More accurately, it should be called something along the lines of the "Underwood Tariff Reduction and Income Tax Act." Underwood's political career itself reflected the broad political-economic meaning of the great compromise of 1913. In the teens and 1920s, Underwood maintained that the federal government should permit alcohol and refrain from taxing it, while firmly opposing the resurgent Ku Klux Klan.

To Underwood, Congress' obliging of the longstanding Southern interest in reducing the tariff, dating back to the South Carolina nullification contest of a century before, was precisely the olive branch that the South had always been looking for. Once it was proffered, it was time for the South to take leave of its dis-unionism. Moreover, in the interest of a diversified tax base, such as the nation had sorely lacked during the era of tariff dominance, Underwood did not want the Temperance movement to take away (as it would with Prohibition) an essential source of revenue for government at all levels.

As of 1913, the American political economy had reached an uncommon point. The sense was strong that the best form of taxation was one broadly-based at the lowest rates. There would be a modest income tax, a (more) modest tariff, and some sales taxes (on alcohol). Somehow, this rather welcome new consensus, a consensus which respected the economics of taxation, would prove nothing more than a flash in the pan.

Three Reasons for Tariffs

The tariff has a special nature as a tax. It is not a tax on earnings (as in an income or other direct taxes), on transactions (as in a sales tax), nor on wealth (as in an excise or property tax). It is rather a tax on goods intended to be sold. Classically, a merchant pays tariff duties at the customs house upon disembarking from a ship filled with goods. The duties are assessed once agents check the ship's manifest against the cargo and the tariff list. Duties can be either a specific amount—ten dollars per pair of eyeglasses, for example—or "ad valorem." An ad valorem tariff, or an "impost," is a percentage rate on the value of goods based on how similar goods are priced in that "time and place," in the language of the original United States tariff acts. The tariff is payable before any imports are sold and thus monetized, even at the wholesale level.

Finance, therefore, has a special role to play in tariff economics. Part of the freighting fee for imports being brought to market is whatever duties the tariff requires. An importer, and the importer's bankers, have to have confidence that the goods brought into port will easily sell at a price that will clear all costs, inclusive of the tariff duties. These realities generally make the tariff an elastic form of taxation. An increase in rates, even a small one, can scuttle a project to bring goods across the ocean to America; and a decrease, again even a small one, can provide clearance for such a project. This is the Laffer Curve at work.

With that said, there are three major reasons a government might seek to impose tariffs:

1. The first is the most obvious: to *raise revenue*. How much revenue a tariff can raise is a highly variegated matter. There are duty rates on goods that can be high without discouraging importation and prospects for sale, and there are duty rates that can be low, yet still large enough to cut off all importation. The Laffer-curve optimal rate of taxation—the point at which either raising or lowering a duty would decrease revenue—is unique in each case and context of an imported good.

[6] Phillip W. Magness, "From Tariffs to the Income Tax: Trade Protection and Revenue in the United States Tax System," Ph.D. diss., George Mason Univ., 2009, 249.
[7] "Merchandise Imports and Duties," *Historical Statistics of the United States*.

A revenue-maximizing tariff, therefore, consists of a list of duties, each of which is revenue-maximizing for the particular good it refers to. Under a revenue-maximizing tariff, if such a thing could be implemented, a country would be flush with imports, a necessary condition for revenue maximization. To be sure, a revenue-maximizing tariff is an ideal type. In practical terms, it is impossible to produce a truly revenue-maximizing tariff consisting, as it must, of a complete list of individual revenue-maximizing duties.

The first problem here stems from economics. What a revenue-maximizing rate is, for each and every potentially imported good into a country, is a nigh unascertainable matter. Yet even if this (ever-changing) information could somehow be discovered or deduced, a simple political matter would remain. This information would have to be communicated to Congress. In turn, Congress would have to construct a tariff that both respected this information and retained the flexibility to change with the surely constant changes in the information.

Approximations of revenue optimization are the most any legislated tariff can aspire to. It is not merely a matter of setting a flat, non-discriminating rate. If each good has a unique capacity to bear taxation, a flat rate, by definition, will be inefficient to some degree.

Congress' tariff efforts, in eras in which federal revenue needs were acute, endeavored to reach these approximations. The Revenue Act of 1789, for example, came as Congress faced its constitutionally obligated responsibility to pay off the accumulated debts of the states. That act consisted of a flat rate, 5% ad valorem on all imports, except those provided on a list that gave duties on specific products. The 1789 Act had the form of a tax law aspiring to approximate revenue maximization. It provided a list of duties on specific imports whose taxation nature was presumably known to the Congress, while declaring a low, flat rate on everything else.

2. As an historical matter, however, we know that the list elucidated in the Revenue Act of 1789 did not correspond in every case, or indeed in most cases, to a sense on Congress' part of revenue maximization. Rather, the specific duties corresponded to efforts at *protection*. This is the second reason a government may wish to impose a tariff.

A protective tariff has a simple definition. It is one in which rates are beyond the revenue-maximizing point. If by raising a rate, less revenue results, necessarily less of the good is being imported. And if by lowering a rate, more revenue results, necessarily more of the good is being imported. Therefore, that tariff rate resulting in less revenue is also that tariff rate resulting in less importation—and is thus protective. "Protective" refers to the domestic industries that compete with imported goods for sales. A protective tariff duty on a good is one that enables a domestic producer to sell at above what the market price would be in its absence.

As should be obvious at this point, the ideas of a revenue tariff and a protective tariff are not mutually exclusive. As tariff rates increase above the revenue-maximizing rate, revenue is increasingly exchanged for protection. A tariff serves both masters.

From an economic perspective, a protective tariff of necessity must result in major inefficiencies—major "deadweight losses," as Arnold Harberger of the University of Chicago termed it in the 1950s. A protective tariff makes prices of the tariffed imports clear at higher levels than otherwise. Tariff protection insulates domestic businesses from the heat of competition, enervating them as enterprises.

From a political perspective, the problems are arguably more acute. When Congress makes specific duty rates in a tariff beyond the revenue-maximizing point, it is inevitably because of pressure and lobbying from those with a narrow self-interest in seeing such an outcome. The information flow to Congress, in terms of what imports should be taxed and by how much, is a hostage to the domestic beneficiaries. There may be the occasional researcher or academic who makes suggestions to Congress about setting a tax rate. Such examples, however, pale in comparison to the profusion of well-heeled lobbyists striving to secure Congressional approval of duty rates favorable to clients who are paying them for that purpose.

Historically, this lobbying aspect of protective tariff rates is what led to political tension and further unrest. The near-60% rates of the 1828 Tariff of Abominations sucked income out of every American, but it was the "system of plunder" and "traffic of interests," as John C. Calhoun's biographer Margaret Coit quoted that crucial figure, inherent the protective tariff that set the South and much of the nation off in that instance.[8] Similarly, the income tax of 1913, aimed at high earners, was a gesture toward recapturing the gains that had accrued to the narrowly self-interested businessmen who had sustained the high tariffs of the era of 1861-1913.

[8] Margaret Coit, *John C. Calhoun: American Portrait* (Columbia: Univ. of South Carolina Press, 1991), 231.

Another political-economic problem in protective tariffs is that their implementation means that other taxes have to be raised. If a tariff rate can be lowered for more revenue, its existence means that the other tax rates in the system bear the load of the foregone revenue. The consequences can be profound and include vicious circles. If a domestic industry is protected with a high rate, it and the other rates that, of necessity, are higher than they otherwise would be, cramp the competitiveness of all businesses in the country. These businesses become less competitive against foreign competition. This in turn increases and intensifies the call for tariff protection from other imports and for more encouragement of domestic exports. If further protection comes, the original problem worsens. This is the essence of a tariff war. A tariff war can, strangely enough, even take hold domestically, without any tariff retaliation from a trading partner.

Protective tariffs also invite evasion and crime. Non-protective tariffs by definition coincide with licit trading activity, in that they are productive of revenue. When protective tariffs are introduced, they cause a pile-up of foreign inventories of otherwise salable goods in the tariff country. Intrepidness in bringing these goods to market into the tariff country "undocumented," as it were, is stimulated.

A major reason the United States ultimately departed from tariffs as its major revenue source, as the nineteenth century gave way to the twentieth, was its progressive acquisition of major land borders in the middle nineteenth century. The U.S. tacked on three roughly 1,500-mile land borders from 1848-1867. These were the borders with Mexico, that with Canada along the continental United States, and that with Canada along Alaska. Tariffs made most sense when shippers had to come into a well-established port in order to have any hope of off-loading their cargo. In the early history of the United States, these ports of entry amounted to a handful—Boston, New York, Philadelphia, Charleston, New Orleans. The government could set up a customs house and some guns and expect everyone to pay up.

With improvements in shipping techniques (in particular speedboats, trucks, and airplanes), it became possible to run goods into the country outside such established ports, such as the nation would see to great effect during Prohibition. The acquisition of huge land borders transformed the practicability of the tariff. A border such as that with Mexico was porous at every point. Indeed, as that border was established in 1848, unlike the previous border between the Louisiana territory and Mexico and the Spanish Viceroyalty, most inhabitants in the area regularly traded with each other across it. The idea of making all those transactions taxable brought an order of difficulty which the tariff had never before seen.

It is a distinct irony that the recent U.S.-Mexico tariff crisis was occasioned by immigration trouble at that very border. One of the central reasons the United States began to talk itself out of a tariff as its major form of taxation, in the nineteenth century, was that the Mexico border made the tariff there unworkable, indeed an object of flouting. Some of the confidence the South had, misplaced as it may have been, in its bid for secession in 1861, derived from the open mockery of the tariff, and thus federal sovereignty, that was on display across the Texas-Mexico border from 1848-1861.

3. Misbehavior on the part of foreign countries is the grounds for the third reason governments impose tariffs. Countries can impose tariffs *as a tool to procure foreign-policy goals*. President Trump has said that one of the reasons—perhaps the chief reason—he has pressed for tariffs is to expose the current trade barriers the United States' trading partners have in place, in the interest of reducing or eliminating them. If in the passage of the 16th amendment, the income tax was a club to beat down the tariff, so can a tariff be designed to be the club to compel alternative policies from trading partners.

Tariffs, like taxes, can be punitive, revenue raising, and behavior altering.

A tariff of this sort can be availed against allies and adversaries. President Trump's tariffs against Canada, Mexico, South Korea, and the European Union are tariffs against allies, professed in the name of changing their behavior, behavior regarding their own trade policies. A tariff of this sort can also be directed, oddly enough, at elements of the domestic population. President Trump's tariff against solar panels was an effort, in his estimation, to disrupt the indulgence of an ecological fad within the United States, namely an overweening interest in renewable energy.

A more serious form of tariffs in this category, in terms of geopolitics, are those tariffs that can be put up against nations that are abusing international norms. Sanctions such as the United States has imposed against Cuba, North Korea, Iran, Venezuela, and Russia, include tariffs and U.S. export restrictions among other strictures. Further tariff-like barriers in this category include the provisions of the Trading With The Enemy Act of 1917 and the concept of Most Favored Nation status in international trade. From the perspective of economic efficiency, putting up a tariff as a sanction is better than a quota only in that a tariff provides some revenue to the home government.

The Constitution allows the Congress the power to levy "taxes, duties, imposts, and excises" and confers on the president the power to conduct foreign policy. It is within the Constitutional order for the president and the Congress to cooperate in the use of tariffs for foreign-policy ends. Nothing in the Constitution would appear to disallow it.

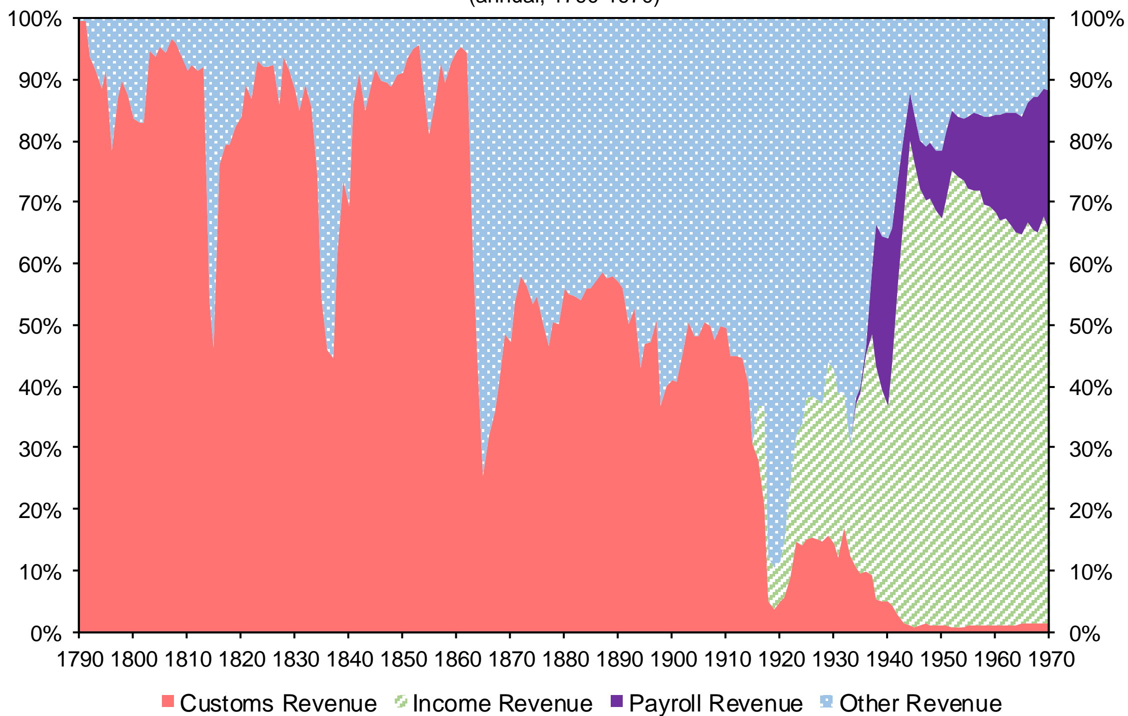
The 20th and 21st Centuries

Impact of the Revenue Act of 1913

When the tariff was the dominant form of taxation in the United States (Figure 3), in the years prior to 1913, it accounted for most of federal revenue. In its heyday, the tariff's share of federal revenue generally did not fall far below 50%, and only did so when alcohol and tobacco tax revenue surged in the years just prior to 1913. In turn, the size of the federal government was small compared to today's standards. Outside of times of emergency, such as the Civil War, the federal government accounted for between 2% to 3% of GDP.

Average tariff rates in roughly the century prior to 1913 ranged between 25% and 60%. Tariff rates at these levels resulted in 2-3% of government revenue as a share of GDP. This was an important connection. If the tariff was to be the major, even exclusive, form of federal taxation, the government would be limited in size. Imports were not large enough a share of the American economy such that they could be taxed, even at the revenue-maximizing rate, for government to get any larger. One of the implicit trade-offs of the tariff was that however odious it may have been as a favor-trading machine between business and Congress, if it predominated in the American tax system, government had to stay satisfied with remaining small.

Figure 3
Composition of Federal Revenues
(annual, 1790-1970)

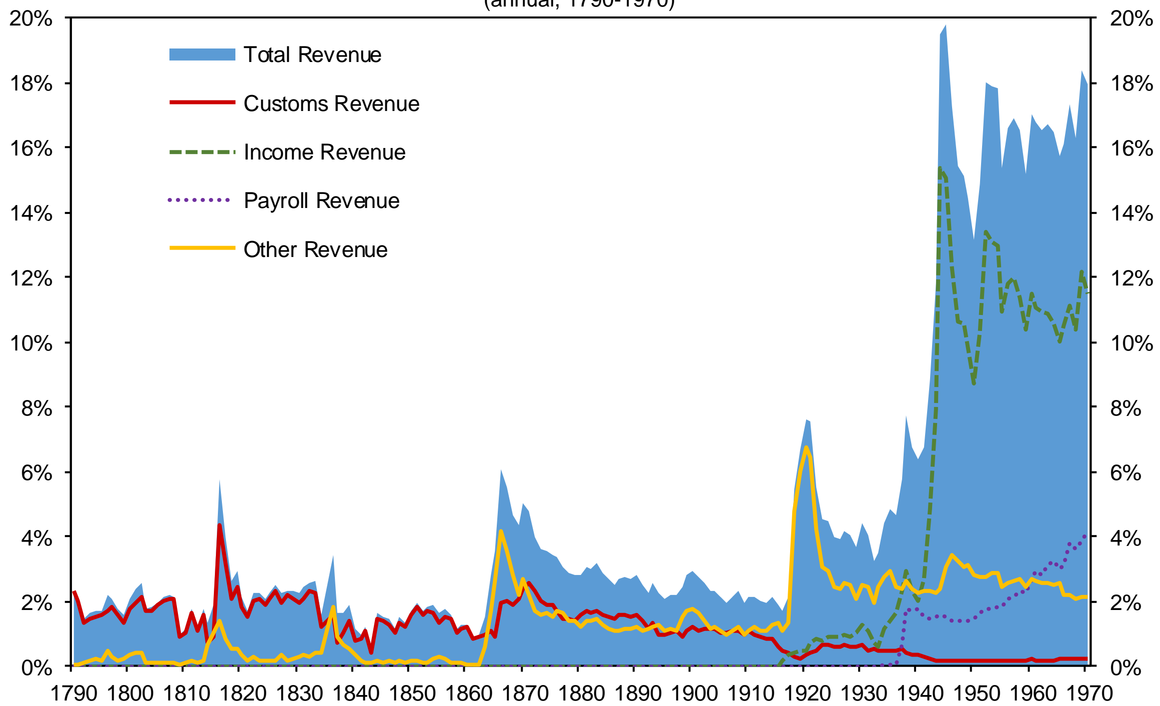


Source: Historical Statistics of the U.S., The Office of Management and Budget

A profound effect of the compromise of 1913, when the tariff was reduced with the newly Constitutional income tax, was that it introduced a means by which the federal government could at last grow larger (Figure 4). In the language of taxation dating back to the Constitutional era, the tariff represented "external" taxation and taxes on the domestic population "internal" taxation. The chief form of internal taxation was now the income tax. Its potential claim was not the value of all imports coming into the country, a relatively confined number, but no less than the entire new wealth created by inhabitants of the nation every year.

The original income-tax law of 1913 did not have aspirations in this direction. Its highest rate was 7%, and it began to apply only after deductions that were well past median income. In no time at all, however, the income tax did have such intentions. By 1918, the top marginal rate of the income tax was 77%. From the 1940s until 1963, the top rate was 91% and the bottom rate 20%, with a schedule of rates in between that quickly increased income. These income-tax schedules indeed implied that this form of internal taxation was bent on confiscating the greater part of nearly all income in the United States. This confiscation did not happen because of the contradictions to these schedules—the exemptions and the loopholes—that populated the back pages of the income-tax code. These were similar to the tariff list of old. Each one had come care of the nexus of special-interest lobbying and the Congressional bill-writing and mark-up process.

Figure 4
Federal Revenues as a Share of GDP
(annual, 1790-1970)



Source: Historical Statistics of the U.S., The Office of Management and Budget

The federal government's displacement of the national economy in the era of the income tax came to greatly exceed what had been the norm under the tariff. In the 1920s, the outlays of the federal government stayed confined, at about 4% of GDP compared to the 2% to 3% norm prior to 1913. The difference came not from new government programs, but the World War I debt obligations. Things changed in the 1930s, as the outlays figure zoomed to 10%. After World War II, it went into the high teens, and since the 1970s it has regularly been above 20%.

In addition, the size of state and local government has increased well beyond the 3% to 4% norm of the pre-1913 era. Now, state and local government accounts for approximately 15% of GDP. One of the reasons is that the federal acquiescence to an income tax has led to copycat income taxes in the states. This total share of government had held at approximately 6% of GDP in the tariff-dominant era, it accounts for beyond a third in our contemporary income-tax era. This pattern of behavior was not unique to the U.S. Similar patterns, often more extreme, were a global phenomenon.

The prodigious ability of this form of internal taxation to capture revenue from the inhabitants of the nation led to a transformation in the tariff. In the era of the income tax, almost all tariffs became protective. The revenue claims of an optimal tariff came to be so small in comparison to what the income tax could rake in that they were not worth Congress' attention. Lobbyists for special interests still wanted tariff protection here and there, and this became the exclusive preserve of tariff politicking.

The Fordney-McCumber Tariff

In the 1920s, there was an effort to undo the compromise of 1913, and it produced contrary effects. The 1922 Fordney-McCumber tariff increased duty rates by about 15%, just as Congress was passing income-tax rate cuts and preparing for more of the same. Pat Buchanan made a false claim in his aforementioned article when he wrote that the 1922 tariff "gave Presidents Warren Harding and Calvin Coolidge the revenue to offset the slashing of Wilson's income taxes, igniting that most dynamic of decades—the Roaring '20s." The 1922 tariff was one of the last to increase revenue—but this did not offset any losses on the income tax side. Due to the Laffer curve effect of tax rate cuts in the 1920s, there were only increases in tax revenues from that source. The losses in tax revenues in the 1920s were on the alcohol side, care of Prohibition. The circa $250 million increase in yearly customs revenue in the several years after 1922 was the amount the government did without in forgone alcohol-tax receipts.[9] No big deal.[10]

[9] See Federal government revenue by source, 1902-1995, *Historical Statistics of the United States: Millennial Edition Online* (Cambridge University Press, 2019)

[10] Brian Domitrovic, "The Tariff or Tom Wolfe? It's Hard to Tell," Forbes.com, July 7, 2019. https://www.forbes.com/sites/briandomitrovic/2019/07/07/the-tariff-or-tom-wolfe-its-hard-to-tell/#36040ed679c5.

Individual income-tax revenue increased substantially in the 1920s, by a more than a half in real terms from 1921 to 1928 as income tax rates were cut by more than 50%. The income-tax rate cuts of the 1920 were so effective on Laffer-curve grounds that they resulted in a cascade of revenue to the Federal Treasury—they provided the revenue to justify both the income-tax cut and a protective tariff. Total income-tax receipts in the latter 1920s, after all the rate cuts, were four times greater than concurrent customs receipts. Indeed, customs receipts in the seven years after the Fordney-McCumber tariff were less than the budget surpluses of these years. The income tax had made the tariff irrelevant from a revenue perspective.

The income-tax rate cuts in the 1920s resulted in a greatly reduced tax burden on those in the lower earning brackets. Internal Revenue Service data show that these dramatic tax cuts resulted in an increase in the share of total income taxes paid by those making more than $100,000 per year from 29.9% in 1920 to 62.2% in 1929. This increase is more significant than it appears, given that the 1920s were a decade of falling prices. A $100,000 threshold in 1929 corresponded to a higher real income threshold than in 1920. The Consumer Price Index fell a combined 14.5% from 1920 to 1929. In this case, the effects of "bracket creep" that had existed prior to the federal income tax's being indexed for inflation (in 1985) worked in the opposite direction.

Far from displacing the income tax as its rates were cut, the tariff, as its rates increased, played an ever smaller comparative role in the federal revenue picture after 1922. This solidified the tariff's function as purely protective—an aspect it had never had before in American history. Even in the Tariff of Abominations era, when the tariff was distinctly protective, it had to retain strong revenue components, owing to the fact that it represented the only form of federal taxation and the United States was still paying off a major war debt (that of 1812). In the 1920s, with a debt far larger than any it had had before (that of the Great War), the United States ran budget surpluses in every one of the eleven years from 1920 through 1930, as income tax-rates were cut substantially. The tariff had lost meaning as a revenue device. This made its protective possibilities shine through like never before. One of the consequences was the Smoot-Hawley tariff, which was a principal cause of the Great Depression.

The parade of lobbyists that came through Congress from 1928-1930 (prefiguring the "Gucci Gulch" lobbyists who lost out in the Tax Reform Act of 1986) to cajole into being what became the Smoot-Hawley tariff of 1930 still represents one of the strangest episodes in all of American political history. Congress took testimony on this tariff over the first seven months of 1929 from 2,100 individuals. This testimony filled 19,000 pages. 1929 was the capstone year, of course, of one of the very best eras in the legendary history of American prosperity. The idea that American business needed protection in the high season of the Roaring 1920s, the Jazz Age in its push past even the years in which F. Scott Fitzgerald produced *The Great Gatsby* of 1925, lacked all credibility.[11]

The irrelevance of the tariff for revenue purposes in the 1920s, after the Treasury Secretary Andrew W. Mellon income-tax cuts had secured revenue beyond imagination, was essential to the gestation of Smoot-Hawley. Special interests were now under no obligation to counter objections from Congressmen about the revenue loss from a protective duty. The only thing at risk was a portion of the federal budget surplus. The income tax at its new low levels would take care of everything up to that. It was open season for getting products on the tariff list. Few saw the dangers of protective tariffs to the economy at large. The ability to tap the reservoir of public largess was essentially seen as infinite.

In his 1978 book *The Way the World Works*, Jude Wanniski (who worked closely with Arthur Laffer for the supply-side cause), charted how the stock market, in 1929 and 1930, followed the fate of Smoot-Hawley in Congress. When the bill flagged, the market went up, and when it gained steam, stocks fell. Wanniski's analysis remains powerful. What remains a fact of chronology is that Congress busied itself with a mega-tariff over the first half of 1929. Congress spent those last months before the Great Depression soliciting testimony about why the nation needed a tariff. Then in the latter half of 1929 and the first half of 1930, legislative politicking took place that resulted in a law passed and signed in June 1930. And so the tariff—and the Depression—came.

The Smoot-Hawley Tariff

After the stock-market drop, and then a notable market recovery, of late 1929 and early 1930, Congress proceeded to fold like a tent on the tariff. As it did so, a vicious circle was engaged. More and more lobbyists—some of whom had just made pitches to otherwise uninterested successful businessmen to hire them—showed up in Washington, as it became clear that tariff bidding was occurring. In June 1930, against the advice of 1,000 economists who had signed a letter to that effect, President Herbert Hoover signed the House-Senate compromise that took the average tariff rate to just about 60%, covering a list of goods unheard of it its vastness and specificity.[12]

[11] For details on the Smoot-Hawley tariff, its legislative history, provisions, and economic impacts, see Douglas A. Irwin, *Peddling Protectionism: Smoot-Hawley and the Great Depression* (Princeton: Princeton University Press, 2011).
[12] *Ibid.*

This Smoot-Hawley tariff killed the goose that laid the golden egg. Its 95-page duty list subjected thousands of products to either ad valorem or specific duties or both. Taxing all the duties together, in June 1930, the tariff increased customs rates from the post-1922 average by about 14%, to a level of 44%. Then something nasty happened. As deflation set in after 1929, the tariff's specific duties increased in real value. To take representative examples, the Smoot-Hawley statute specified that imported plaster was to be dunned at $1.40 per ton, plate glass at 13-20 cents per square foot, and combs at 2 cents apiece plus an ad valorem rate. From June 1932 through the end of 1932 the general price level declined by 22%. This meant that the $1.40, the 13-20 cents, the 2 cents, and all the hundreds of specific duties like them in the law increased in real value by 100/78, or 28%. By 1932, the average duty on goods dinged by Smoot Hawley was no longer 44%, but 59%, the highest in history.[13]

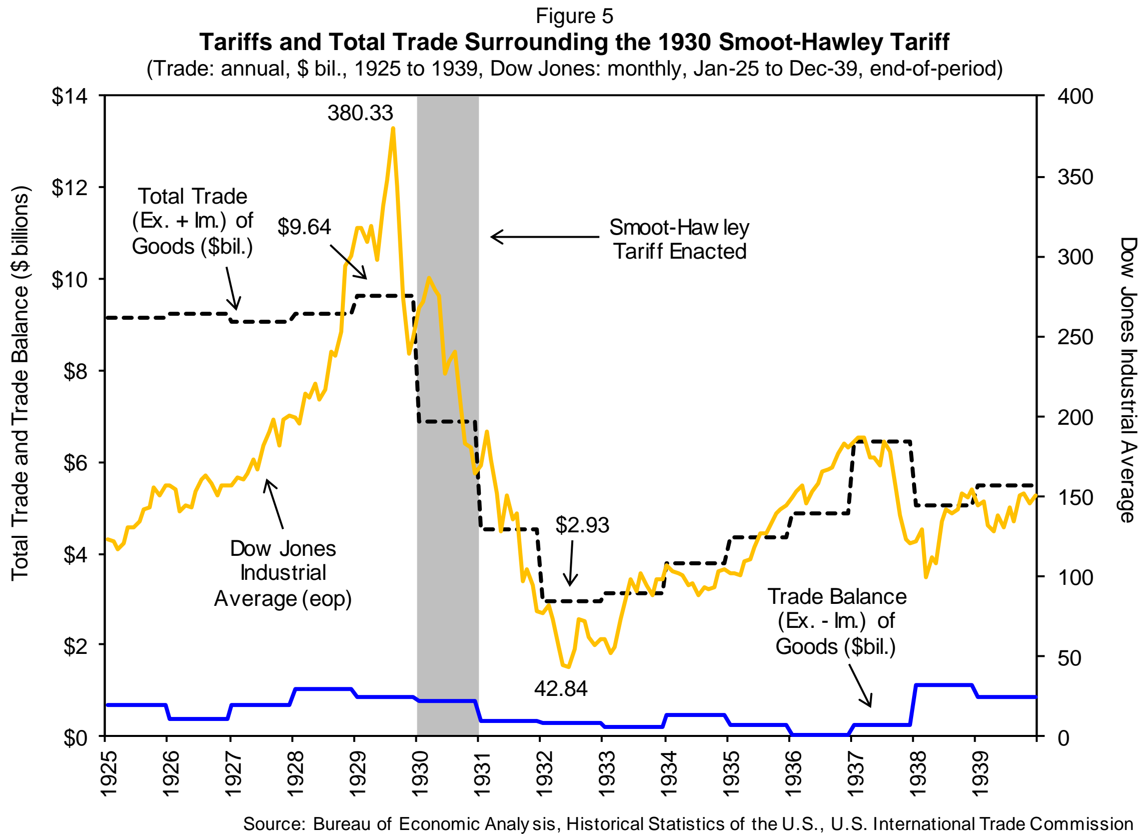
It was not merely customs revenue that collapsed under the weight of these duties—another example of the Laffer curve at work. The payments systems supported by importation also lost their functionality. The World War I reparations system was the major example. In the 1920s, in an intense diplomatic effort that probably stopped World War II from starting then and there, the United States had guaranteed the German reparations of the Versailles agreement. It did so by committing hundreds of millions of dollars of home banking capital to German reparations bonds. As this capital, and the profits it engendered, was cycled through the reparations process, the Allies resumed their payments to American creditors on loans that had been made during the Great War. By setting up a progressively rising barrier to German earning of dollars, the 1930 tariff ruptured this payment process. It turned American-held assets represented by both the foreign World War I debt and the reparations loans of the 1920s into shells of their former selves, if not nothing. By making it nearly impossible for German goods to enter into the country at a saleable price, Smoot-Hawley saw to it that major elements of American credit portfolios became non-performing.

We have heard so much about the banking-reserve crisis of the early 1930s, of the Great Contraction that thundered this nation down into the pit of the eternal Great Depression. Typically, we focus on the haplessness of the Federal Reserve as it failed to manage this situation. It is imperative to note that this historic, hellish banking crisis had a major assist at its point of origination from fiscal policy, namely the Smoot-Hawley tariff. Over the five years prior to 1930, American diplomatic efforts had arranged for a series of major infusions of trade-sensitive financial assets into American portfolios. That the United States then imposed a tariff in this situation is almost unthinkable—it was an unconscious act of self-mutilation. That a financial crisis followed Smoot-Hawley was only natural.

Figure 5 below illustrates the devastating effect this tariff had on total trade (exports plus imports), with the concurrent record of the stock market and unemployment. This encapsulates the story of the Smoot-Hawley Tariff catastrophe. It entailed the demise of President Hoover's Administration and the U.S. economy (and paving the way for the New Deal). Thus began the Great Depression.

[13] "An Act to Provide Revenue…." (the Smoot-Hawley Tariff), *Statutes at Large* 46 (chap. 497), pp. 602, 606, 668.

Figure 5
Tariffs and Total Trade Surrounding the 1930 Smoot-Hawley Tariff
(Trade: annual, $ bil., 1925 to 1939, Dow Jones: monthly, Jan-25 to Dec-39, end-of-period)

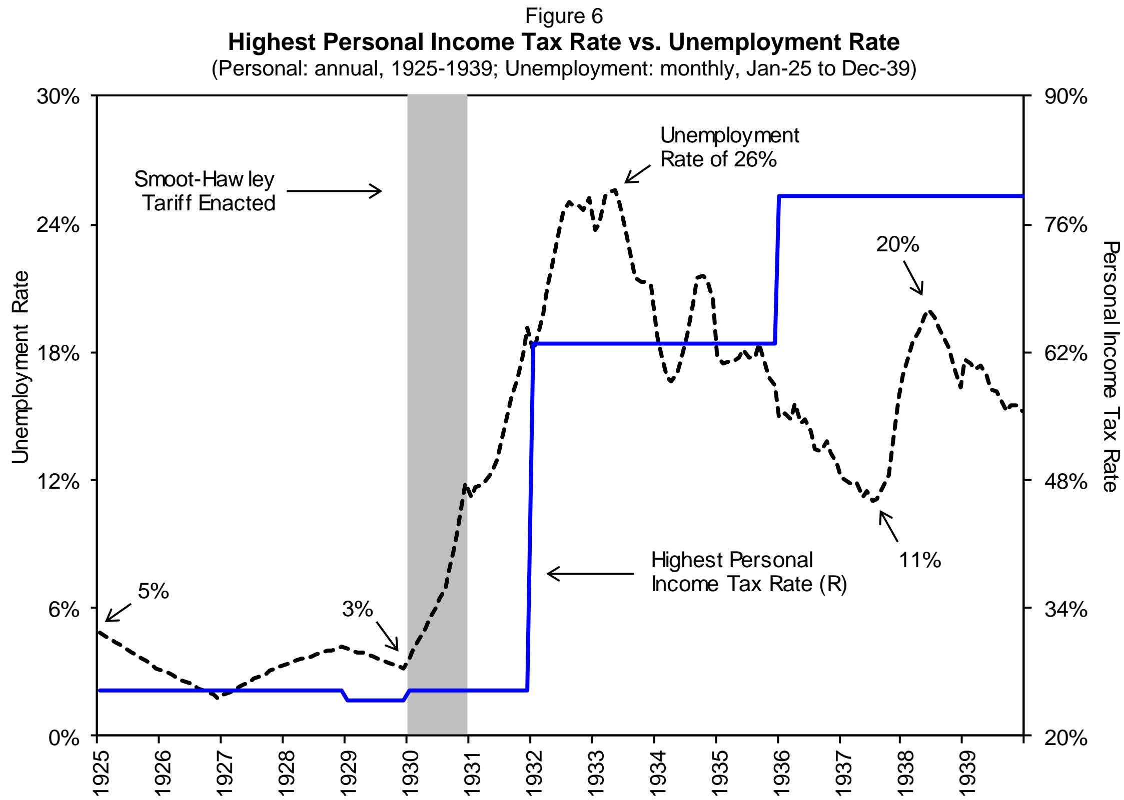


Source: Bureau of Economic Analysis, Historical Statistics of the U.S., U.S. International Trade Commission

The lesson is that trade protection measures destroy the gains from trade by lowering total trade (exports plus imports), but create no jobs, as shown by the trade balance (exports minus imports). By virtue of these inefficiencies, protective tariffs result in a decrease in individual and corporate income. In turn, there are lower tax receipts from those non-tariff sources. As it was in the past, so will it be in the future.

The Smoot-Hawley tariff was the largest peacetime increase in U.S. taxes on traded products ever. Federal revenue from *all* sources plunged as a result. In a hopeless attempt to address this matter, there were huge federal and state internal tax rate increases in 1932. It was a vicious circle. The internal tax increases doubled down on the initial decline in the economy that had been brought about by the external taxation, the tariff. Additional large internal tax increases in 1936 were the proximate cause of the economy's further relapse in 1937. In the 1920s, income-tax rate cuts had resulted in economic growth and a budget surplus. In the 1930s, tariff and income-tax increases (and increases in sales and property taxes) occasioned an historic economic contraction and financial catastrophe, as well as the first peacetime era of chronic budget deficits.

On January 1st, 1932, the lowest personal income tax rate was raised from less than one half of one percent to 4% and the highest tax rate was raised from 25% to 63% (Figure 6). The corporate tax rate was raised from 12% to 13.75%. The highest inheritance tax rate was raised from 20% to 45%, and the gift tax was reinstituted at 33.5%. In 1929 state and local taxes were 7.2% of GDP and then rose to 8.5%, 9.7% and 12.3% for the years 1930, '31 and '32 respectively.



The economy got a lot worse, and President Hoover was resoundingly defeated in November 1932 by Franklin Roosevelt.

Continued Impact on the New Tax System

In early 1933 the federal government declared a bank holiday, prohibiting banks from paying out gold or dealing in foreign exchange. An executive order made it illegal for anyone to "hoard" gold and forced everyone to turn in their gold and gold certificates to the government. The exchange price was $20.67 per ounce of gold in return for paper currency and bank deposits. All gold clauses in contracts private and public were declared null and void. By the end of January 1934 the price of gold (now that most gold had been confiscated) was raised by the government to $35 per ounce. In less than a year, the government transferred from private ownership to itself as much gold as it could at $20.67 an ounce and then devalued the dollar in terms of gold by almost 60%. The confiscation cost gold holders in forgone gains over $6 billion in 1933 dollars when nominal GNP was $57.5 billion. That's one helluva tax, too.

In 1934 the highest estate tax rate was again raised from 45% to 60% and then to 70% in 1935. The highest gift tax rate went from 33.5% in 1933 to 45% in 1934 and 52.5% in 1935. The highest corporate tax rate was raised to 15% in 1936 and in 1937 a surtax on undistributed profits up to 27% was enacted. Finally, in 1936 the highest personal income tax rate was raised to 79%. The payroll tax rate was introduced at a rate of 1% of payroll in 1936, before increasing to 2% in 1937, and 3% in 1938. Doesn't all of this sound depressing both literally and figuratively?

The damage to national income from the tariff's effects brought about an additional Laffer-curve collateral impact on the nation's new tax system. Now internal taxation could not cover revenue needs anymore. The great tariff depressed income, and therefore income tax receipts tumbled—after all their rising under tax-rate cuts in the 1920s. As befits a comedy of errors, the patient then got bled. The die of the Great Depression was cast by the tariff. The tariff's fiscal legacy was not merely the collapse in trade, but the tremendous internal tax increases that came on account of that collapse in trade. These tax increases perpetuated the Great Depression, making it last the entre decade of the 1930s. Had the tariff not come in 1930, the process might not have ever been joined.

Keynesianism arose in the 1930s as a love song to governmental budget deficits. Indeed, in the high season of the New Deal in the mid- and late-1930s, the federal budget was in deficit at the healthy level of 5% of GDP. It must be understood, however, that these deficits existed in the context of uncommonly high tax rates and tax-rate increases. Never before had the United States had both an excessive tariff and an excessive income tax. Now it did. To be sure, care of several bilateral agreements and a mild inflation after 1934, average tariff rates went down to about their Fordney-McCumber levels. But not only were these rates historically high, they now applied to less potential foreign imports on account of the bad blood that had been brought forth by Smoot-Hawley. Moreover, Roosevelt only built on the precedent of the 1932 income tax increase. He took rates at the top and bottom to new highs and envisioned a cap on individual income beyond which the tax rate would be 100%.

The horrors of World War II convinced American policymakers that playing nice with foreigners would be of paramount value in the future. At the 1944 Bretton Woods conference and elsewhere, the goal was outlined of a zero-tariff world. Roosevelt was emboldened by the nosebleed income tax. He would have no need for tariffs—taxing the domestic population exclusively, mainly through the income tax, had proven itself as a revenue engine, deficits notwithstanding.

Several problems remained. The first was the experience under Smoot-Hawley. If the tariff is not needed for revenue, it only stimulates more lobbying, in that lobbyists no longer have to counter the claim of revenue loss. Envisioning this roadblock, officials set up international organizations, the General Agreements of Tariffs and Trade and its successor the World Trade Association, to compel nations into court if they set up trade barriers. The tariff lobbyists now would have to answer for that.

A perhaps even more serious problem, and one that probably played a role in the mentality of the Trump electorate of 2016, was that zero tariffs mean domestic taxation. It was one thing for Roosevelt to have expressed a fond hope for a world at peace under the auspices of zero tariffs. It was quite another to do so while tax rates ran from 20-94% and tax withholding from paychecks was introduced (as it was under FDR in 1943). At some point, the domestic population is going to cry foul. It would appear to it that it was paying for a peace that foreigners should contribute to as well.

Conclusion

It is no historical anomaly that in the era in which free-trade principles have been ascendant—the era after World War II—levels of internal taxation have been very high. In the era of the tariff (before 1913), governments had far from accounted for 20-35% of GDP, as has been the case consistently in the United States since 1945.

A chief reason for government's largeness in contemporary times, it must be understood, is the implication of free trade. Free trade necessarily puts the onus of taxation upon domestic sources. Domestic sources are subject to the full force of the law. Foreign sources are not—tariff duties are only assessed and paid when goods arrive in America and become, geographically, part of the American power system. Therefore, domestic sources can be squeezed to a far greater extent, via taxation, than tax sources are under a tariff regime. As the nation opted for the principle of free trade after the Second World War, it enabled government to get far larger than it could ever have been otherwise—via domestic taxation.

To be sure, the post-World War II era was imperfectly a free-trade era. The rhetoric of free trade often outpaced the reality. Yet for all the truck tariffs, the import surcharges, the oil duties, the auto quotas, and the steel protections, free trade has made its progress. The total volume of trade in the U.S. economy (exports plus imports) has grown to near 30% of GDP, a percentage far higher than in the old tariff era. Most of the imports included in this trade is un-dutied or lightly dutied (average duty rates had fallen under 5% by 2000). Tariff revenue to the federal government has been miniscule in recent decades, at about 1% of federal receipts.

As overly doctrinaire free-trade economists appear not to comprehend, the public seems to have an intuitive sense of the trade-off implied in free trade. There must be domestic taxation. This would be acceptable, perhaps, if that domestic taxation were kept modest, as it was in the 1920s. This is not the case today, however, in that the federal government consumes nearly $5 trillion a year (a very small fraction of it from tariff revenue), the states several trillion more. This kind of governmental engorgement is unthinkable in a tariff system, in particular in a protectionist tariff system, in which revenues are designed to be low.

From the perspective of economic efficiency, what bears taxation the best is the superior candidate for taxation. If taxes can be imposed (or raised) on a good, or on a kind of income flow, or on a category of property, without diminishing that thing, then the tax system is not harming the economy. Production and the cultivating of assets occurs despite the tax. If, however, tax rates diminish economic resources and flows, these rates are, in the name of economic efficiency, to be brought down to the level at which the deadweight loss is minimized—the principle behind the Laffer curve.

In its heyday, the tariff was one of the best exhibits of these principles of taxation. When rates were raised on certain products, it became untenable for merchants to arrange lines of credit so as to pay the large duty at the US customs house across the sea, before the goods even hit market. Congress had to be sensitive to this reality, because the tariff carried the load of federal revenue.

With free trade, the revenue vehicle became internal sources, chiefly the income tax. Here the government found that it could tax and tax, even to the point of seriously harming the national economy. At every moment, there was more revenue than could ever have come from a tariff, because the sources were all domestic, all subject to confiscation on the part of the government. Our debate over free trade seems to be missing this essential connection. If we say we should never tax trade, should we not also say we should never tax domestic sources?

Given that the government presumably has to tax something, the lowest, load-bearing rate on any and all sources is surely the most effective tax system from the perspective of economic efficiency. The peremptory mockery of President Trump's tariff push from the economics cognoscenti is misplaced. The strain in American political sentiments in favor of the tariff points to an awareness that categorical advocates of free trade do not possess. The tariff has caused its share of harm in American history. But we have also seen the alternatives to the tariff, and they are monstrous in their own ways, too. The best compromise is for a tax system that prioritizes the size and vitality of the private, the real economy. This would probably take the form of a modest, properly sensitive list of tariff duties in exchange for greatly reduced internal taxation.

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