The Trouble with Tariffs

Market Institute

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A. Introduction

"It's unclear what higher tariffs are achieving but the trade war's costs and collateral damage are becoming more apparent by the day,"[1] declared Colin Grabow, Associate Director of the Cato Institute's Herbet A Steifel Center for Trade Policy/ Mr. Seifel made the comment in an article focusing on the tariff's impact on Bunch Bikes, a small (eight employee) company located in Denton, Ohio that manufactures and sells electric cargo bikes. Like many American manufacturers—large, medium, and small—they rely on imported parts. And like many American businesses, they are being hard hit by President Trump's "liberation" tariffs. President Trump's tariffs[2] have increased Bunch Bikes' production costs by over $1,000 per bike,[3] forcing the company to raise prices.[4] The increased costs have also forced them to cease advertising, thus limiting their ability to grow and forcing them to abandon plans to hire more employees.[5]

Bunch Bikes is just one of the thousands of small businesses negatively impacted by President Trump's tariff policy. According to a poll by the Small Business Majority Association,[6] 72% of small business owners have either had to raise prices and lose customers or absorb costs and shrink their profit margins. This anti-tariff sentiment is also shared by consumers[7]. This is not surprising since the tariffs have caused many businesses, including Target, Best Buy, Macy's, and even Wal-Mart,[8] to raise prices. Defenders of tariffs claim they are necessary to stop foreign companies—often aided and encouraged by their governments—from flooding the American marketplace with inexpensive goods while American exports are subjected to high tariffs and other trade barriers. The supporters of tariffs claim that whatever short-term pain they may inflict will

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[1] How a Small Business in Denton Is Being Harmed by Higher Tariffs | Cato Institute Cato Institute

[2] Trump imposes 10 percent universal tariff, higher for top trade partners - POLITICO, Key takeaways from Trump's 'Liberation Day' tariffs | CNN Business

[3] NEW Update: Answering your tariff questions

[4] President Trump implemented his 90-day reductions on tariffs from China. Bunch Bikes refunded customers who paid higher prices based on the 179% tariff. This is mentioned to show that BB is the type of small business that should be celebrated by our politicians, not punished by bad tariff policies, especially ones who want to Make America Great Again

[5] How a Small Business in Denton Is Being Harmed by Higher Tariffs | Cato Institute

[6] Christmas Cancelled on Main Street? 74% of Small Business Owners Fear They Won't Survive the Year as Make-or-Break Holiday Season Begins

[7] Majority of Americans say tariffs hurt their family's financial situation, are spending more on groceries and utilities: Poll - ABC News

[8] Which Companies Will Raise Prices Due to Tariffs? See the List

be more than made up for by long-term economic gains.[9] This paper will examine the arguments for and against tariffs, drawing not just on economic theory, but also examining the significant and controversial role tariffs have played in American history.

B. What Is a Tariff?

Tariffs, as most people are aware, are a form of taxes imposed on imported goods.[10] Tariffs are collected by the Customs and Border Patrol before the imported products are allowed to enter the United States.[11] They are paid for by domestic businesses, who then usually add the costs of the tariffs to the prices they charge consumers. Of course, consumers can avoid the tariffs by purchasing domestically produced products. However, even if a consumer can substitute a domestic good for the now more expensive (thanks to the government) import, the tariff still lowers consumer welfare. If consumers considered domestic products to be equal in value to foreign ones, the government would not have needed to impose tariffs to increase demand for domestic goods.

Tariffs also have a negative impact on manufacturers and other businesses that use imported components in their products.[12] These businesses are forced to raise prices and hope consumers are willing to pay. Businesses that rely on exports for a substantial part of their business are also hurt by increased tariffs. This is because, as we have seen with the reaction to President Trump's "liberation tariffs,"[13] countries often raise their own tariffs in retaliation, thus increasing the cost of exports.

Tariffs can also harm the businesses and workers that supposedly benefit from them. Tariffs distort the signals sent by the price system. Businesses rely on these signals to determine the most efficient use of resources. Thus, when a business increases its profits because of the government-imposed tariffs on its foreign competitors, the business owners and workers mistakenly believe that they are using their time, money, and talents in the most efficient way.

There are two types of tariffs: revenue and protective. Revenue tariffs are imposed in order to raise revenue for the government, while protective tariffs are intended to "protect" domestic industries from foreign competitors. Of course, a tariff can have both revenue and protective effects. However, the greater the tariff, the greater the protective effect. Higher tariffs drive more consumers away from imports and towards domestically produced products, which results in lower government revenue. A tariff can either

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[9] Tariffs' Long-Term Benefits Are Worth Short-Term Costs | Opinion - Newsweek

[10] What Tariffs Are, How They Work, And Who Pays the Bill

[11] *Ibid*

[12] The Real-World Impact of Tariffs: What Businesses and Consumers Should Know

[13] Here's How Countries Are Retaliating Against Trump's Tariffs - WITA

maximize the revenue available to the government- or maximize the protection it provides to domestic industries. It cannot do both.

C. History of Tariffs

"Whereas it is necessary for the support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufactures, that duties be laid on goods, wares and merchandise imported." – Tariff Act of 1789[14]

Tariffs played a significant role in the economic history of the United States, going back to colonial times.[15] One of the reasons the colonists sought independence from the British crown was "for cutting off our trade with all parts of the world."[16] The Articles of Confederation did not grant the federal government the authority to collect tariffs. Instead, this power remained with the states, who used it to impose tariffs on goods from other states.[17] [18]

The Constitution gave Congress the power to "lay and collect taxes, duties, imposts, and excises."[19] Since the original Constitution forbids the federal government from imposing income taxes,[20] tariffs were the federal government's primary revenue source. This is why one of the first pieces of legislation considered by the US Congress was the Tariff Act of 1789, drafted by James Madison. Madison and his allies expected the simple bill, which focused on revenue tariffs, to quickly pass Congress. However, Pennsylvania Representative Thomas Fitzsimmons introduced an amendment to "encourage the productions of our country and protect our infant manufactures."[21]

This led to other representatives proposing amendments to set "special" tariff rates to protect "special" industries in their states or districts. This kind of lobbying would continue through the 19th century, but played a major role in turning public opinion against tariffs.[22] Madison wrote of the proposals to expand his revenue tariff bill into one

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[14] tariff-act-1789.pdf

[15] Tariffs in Colonialism: A Comprehensive Guide

[16] Text of the Declaration of Independence | Declaration Resources Project

[17] https://www.khanacademy.org/humanities/ap-us-history/period-3/articles-of-confederation-ush-lesson/a/challenges-of-the-articles-of-confederation-article

[18] If the states maintained their authority o elves "tariffs on goods imported from other states" perhaps Donald Trump could have run for Governor of Florida on a promise to impose taxes on cheap goods being imported from Texas.

[19] Article One, Section 8, of the US Constitution

[20] Article I, Section 9, Clause 4: No Capitation, or other direct, Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken.

[21] https://www.cato.org/publications/problem-tariff-american-economic-history-1787-1934#prelude-american-trade-policy

[22] *Ibid*.

that also attempted to protect favored industries that, “if the duties should be raised too high, the error will proceed as much from the popular ardor to throw the burden of revenue on trade as from the premature policy of stimulating manufacturers.”[23] Madison’s support for revenue, as opposed to protective tariffs, put him at odds with his Federalist Papers co-author (and first Secretary of the Treasury) Alexander Hamilton. Hamilton advocated using tariffs to protect “infant” (new) industries from foreign competition.[24]

The “infant industries” argument is a popular justification for tariffs. Economist Murray Rothbard, in his classic monograph, “Protectionism and the Destruction of Property,”[25] wrote of the infant industries argument: “any government subsidizing of a new industry will funnel too many resources into that industry as compared to older firms and will also inaugurate distortions that may persist and render the firm or industry permanently inefficient and vulnerable to competition. As a result, infant-industry’ tariffs have tended to become permanent, regardless of the ‘maturity’ of the industry. The proponents were carried away by a misleading biological analogy to ‘infants’ who need adult care. But a business firm is not a person, young or old.”

A great boom in support for tariffs resulted from the War of 1812, which forced self-sufficiency in America. At the end of the war, some “incidental” protective tariffs remained in place. In 1824, Kentucky Senator Henry Clay proposed his “American” system which consisted of high tariffs, government funded “internal improvements”, and a national bank to ensure government could borrow money in case there was insufficient tariff revenue to fund the internal improvements. Contrary to the myth promoted by national conservatives, Senator Clay’s American system did not actually benefit all of America, much less unify the country. Both Madison and Jefferson opposed the American system’s protective tariffs, with Jefferson drafting a resolution for the Virginia General Assembly condemning the tariffs as unconstitutional.[26]

Clay’s American system hurt the economy of southern states because the agricultural businesses that formed the backbone of those states’ economies were major exporters. Tariffs reduced demand for agricultural exports while raising the prices of many of the imports southern farmers used to improve their productivity. In contrast, high tariffs benefited northern manufacturers who were able to charge above-market prices for their goods thanks to the tariffs. The higher profits generated by tariffs incentivized businesses to divert resources from pleasing their customers to courting favor with politicians.

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[23] *Ibid*.

[24] The Aftermath of Hamilton's “Report on Manufactures” | The Journal of Economic History | Cambridge Core

[25] Protectionism and Destruction of Prosperity.PDF

[26] To James Madison from Thomas Jefferson, 24 December 1825

Clay's American system thus resulted in a system of graft where special interests flocked to DC to hand money to elected officials to influence the tariff rates. The result of this system was the "tariff of abominations." This was an unintended consequence of an effort by free traders in Congress to turn the revised tariff schedule into a "Christmas tree" of carve outs and special interest giveaways in hopes of convincing New England manufacturing interests to oppose the bill. The plan backfired when New England legislatures still supported the bill, resulting in tariff schedules as high as 60%![27]

The tariff of abominations led South Carolina to pass a nullification resolution[28] and then-Vice President John C. Calhoun to resign and return to the Senate. It also caused then-President Andrew Jackson to threaten to send troops into South Carolina and any other state that resisted the tariffs. Fortunately, a compromise was reached, leading to tariffs being gradually reduced to 1816 levels. The fact that the tariffs almost drove the country into civil war certainly disproves the myth that tariffs are unifying.

The post-abomination era of lower tariffs and trade liberation did not last long. The withdrawal of southern legislators from Congress at the start of the Civil War led to the passage of the Morrill Tariff. Like its predecessors, the Morrill tariff was the product of a bidding war between business interests hoping to profit from increased tariffs on consumers. Tariffs remained high following the Civil War, which was also a period of strong economic growth. This has led many tariff supporters to point to this period as proof that tariffs can help grow the economy.

However, as economic historian Douglas Irwin observed, "tariffs coincid[ing] with rapid growth in the late nineteenth century does not imply a causal relationship."[29] Irwin points out that tariff supporters cannot point to any evidence establishing a direct relationship between high tariffs and strong economic growth.[30] On the other hand, opponents of tariffs can point to the continued time and money businesses spent lobbying Congress to influence the tariff schedule as evidence that the American economy would have been stronger had not the promise of increased profits from tariffs caused businesses to divert resources from productive activity to trying to curry favor with politicians.

Irwin also observed that during the 19th century, labor productivity in agriculture was comparable to productivity in the UK, but manufacturing was roughly double that of the UK during the same period. American workers shifted from agriculture to manufacturing, but the "tariff cannot take much credit for this shift because the level of import protection was roughly constant from the Civil War through this period, so its

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[27] https://www.cato.org/publications/problem-tariff-american-economic-history-1787-1934#formalizing-protectionism

[28] South Carolina Ordinance of Nullification | South Carolina Encyclopedia

[29] The Problem of the Tariff in American Economic History, 1787–1934 | Cato Institute

[30] *Ibid*.

effect is already built into the 1870 figure."[31] Irwin also found that, while some infant industries did grow during these years, there is no evidence that it was because of the tariffs. In fact, some infant industries were harmed by the reduction in demand for American exports.

As has always been the case in American history, the post-Civil War tariffs particularly burdened American farmers. Farmers not only faced reduced demand for their products, but they also had to pay more for imported products they relied on to increase their productivity, and thus their profits. Outrage with Congress setting high tariff rates, combined with the growing realization that tariffs benefited some American businesses at the expense of others led to increased support for replacing tariffs with an income tax. Supporters of the income tax promised that—unlike tariffs— income taxes would only apply to the top income earners.[32]

Frank Chodorov, one of the founders of the modern libertarian and conservative movements[33], commented on how those who supported the income tax as a means to get rid of tariffs ended up with both tariffs and income taxes in his classic work, *The Income Tax: The Root of All Evil*:[34]

"The Fordney-McCumber Tariff Act of 1922 (with an average ad valorem rate of 33.22 percent) restored the high protective tariff of pre-income-tax days. Ironically, the agricultural bloc of the Middle West and the South that had fought for the income tax, to enable a reduction in tariffs, joined with their erstwhile opponents to enact this bill. The highest tariff schedule in American history, with an average rate of 40.08 percent, was passed in 1930. It was the Smoot-Hawley Tariff Act."

Chodorov summed up the lessons of the failure to replace tariffs with taxes thusly:

"Hence, the idea that the government would give up tariff revenue in exchange for income-tax revenue was contrary to all experience. It promised to make the swap, and its leaders believed the promise, but the nature of government is such that it cannot give up one power for another; not permanently, at any rate."[35] Chodorov did recognize that the adoption of the income tax changed the focus of tariff policy since the "income tax so enriched the Treasury that the revenue from tariffs became unimportant, and the government could afford to give more and more protection to the manufacturers."[36] Not only did adoption of the income tax not result in the elimination of tariffs, it made

[31] *Ibid*.

[32] The Tariff and Income Tax Toggle | Mises Institute

[33] Founding Individualist – Modern Age

[34] Income Tax: The Root of All Evil

[35] *Ibid*.

[36] *Ibid*.

politicians more willing to increase tariffs since they had an alternative source of revenue to compensate for any losses from protectionism.

Of course, as we are reminded every April 15, Congress did not keep their promise to limit income taxes to the rich. Yet again, Chodorov provides the best summary of the process:

"The income tax rates kept climbing, and the exemptions kept declining; the mesh of the dragnet was made finer and finer so that more fish could be caught. At first it was the incomes of corporations, then of rich citizens, then of well-provided widows and opulent workers, and finally the wealth of housemaids and the tips of waitresses."[37]

Those tempted by President Trump's proposal to use tariff revenue to eliminate taxes on those making under $200,000 a year and provide broad-based tax relief for others[38] should consider this history. Tariffs would have to be raised by as much as 58% to replace the revenue the government receives from income taxes—and that assumes there is no decline in demand for imports because of the higher tariffs.[39]

The Smoot-Hawley tariffs referenced above were a response to the Great Depression. The thinking behind them was that increased tariffs would stimulate American businesses.[40] Of course, they had the opposite effect, as the high tariffs resulted in a trade war. As a result of Smoot-Hawley and other government interventions in the market, the total volume of world trade declined from $3 billion in January 1929 to $992 million in January 1932! The upside of Smoot-Hawley was that it finally discredited the notion that tariffs are an effective tool to promote domestic industries and led to the passage of the Reciprocal Trade Agreements Act, which gave the President authority to negotiate bilateral trade deals. Deals negotiated under this act could become law by a simple majority vote in Congress instead of the two-thirds majority required for a treaty.[41]

D. Conclusion

"Cumulatively, Trump's tariffs impose the largest tax increase on trade in a century. The proponents of tariffs portray these measures as acts of "economic liberation." Instead, tariffs invert the principles of liberty that ushered in an American-led age of human freedom and prosperity," as noted by the Anti-Tariff Declaration, a statement opposing the Trump Administration's tariff policy.[42] President Trump has not only hit the economy with record high tariffs, but he has also compounded the damage with inconsistencies

[37] *Ibid*.

[38] Tariff and Spend - The Ron Paul Institute for Peace & Prosperity

[39] Fact Check: Is it realistic to replace the income tax with tariffs? | Confect

[40] The Problem of the Tariff in American Economic History, 1787–1934 | Cato Institute

[41] The Problem of the Tariff in American Economic History, 1787–1934 | Cato Institute

[42] Reject Tariffs, Restore Trade | Anti-Tariff Declaration

that make markets unpredictable. He has regularly threatened to impose high tariffs on key trading partners, only to then relent.[43] He has also said contradictory things about whether the tariffs are intended to be the foundation of a new economic policy, or simply a tool to bring other countries to the negotiating table.[44] This has introduced uncertainty in the markets which has distracted attention from the damage caused by the tariffs themselves.[45]

Some defenders of tariffs say it is not fair that the US has low tariffs while some of our trading partners impose high tariffs on US goods. They are correct: it is unfair to the workers, consumers, investors, and business owners of the countries that maintain high tariffs and other trade barriers. As Milton Friedman said:[46] "Suppose China were incredibly successful in her alleged attempt to restrict imports into China, managing to dispense with them entirely. Suppose that China was incredibly successful in her alleged attempts to push exports to the U.S., managing to sell us large quantities of assorted goods. What would China do with the dollars she received for her exports? Take crisp greenbacks back to Beijing to stash in the vaults of the Bank of China? Let deposits at U.S. banks pile up? Jolly for us. Can you think of a better deal than our getting fine textiles, shiny cars and sophisticated TV sets for a balance of green printed paper? Or for some entries on the books of banks? If the Chinese would only be willing to keep on doing that, we can provide all the green paper they will take.

"China does impose numerous restrictions on trade—though in recent years she has been reducing them. Those trade restrictions hurt China, and they hurt us—by denying them and us mutually profitable trade. In China no less than in the U.S., concentrated producers exert a greater influence on government than widely diffused consumers and can persuade the government to fleece the consumer for the benefit of the producers. However, we only increase the hurt to us—and to them—by imposing additional restrictions in our turn. The wise course for us is precisely the opposite—to moving unilaterally toward free trade. If they still choose to impose restrictions, that is too bad but at least we have not added insult to injury.[47]

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[43] Trump's habit of threatening to impose tariffs on America's leading trading partners, only to relent, led to design the tariff policy as a TAXO (Trump Always Chickens Out) PolitiFact | Did Trump impose 'the largest tax hike in our lifetime'? How it compares, as it's currently proposed

[44] What Trump actually wants from tariffs | CNN Business, Three key goals behind Trump's latest tariff wave revealed, What are Trump's Tariffs Supposed to Accomplish?

[45] Trump tariff revenue soars 78%. Who's paying them? NPR

[46] The original Friedman quote was about Congress putting restrictions on imports from Japan. During the 70s and 80s, fear that Japan's mixed economy and managed trade would overcome the US was the favorite justification from foes of free trade. Japan's economic slide into stagnation in the 90's has caused them to fail to regain their previous prominence in the world economy. See: In 1970, Milton Friedman Called for Unilateral Free Trade Rather Than Retaliation. We Still Haven't Learned That Simple Lesson.

[47] Ibid

The quote is just as applicable today as it was when it was first written. Free trade benefits American businesses, workers, and consumers. In contrast, protectionism only benefits certain interests whilst raising costs. Tariffs, like all consumption taxes, force them to alter their consumption patterns, thus making them worse off. Tariffs also harm businesses that rely on exports. As we have seen, American farmers have traditionally been victims of tariffs. Today, when imports account for an average of 20% of a typical farmer's income,[48] farmers are once again put at risk by tariffs.[49]

President Trump and his allies may think tariffs will strengthen the American economy, benefiting all Americans. But the truth is tariffs are nothing more than another special interest giveaway to favored corporations and do not hurt foreign businesses as much as they hurt American businesses, workers, and consumers. Tariffs also incentivize businesses to divert resources from finding new ways to please consumers towards making allies in the political class in order to gain profit from the tariff system. This encourages businesses to invest precious money in seeking favors from the government.

Those wishing to help the American people prosper should forget about trying to tariff our way to prosperity. Rather, they should focus on removing regulations that stifle the creation of new businesses and cut government spending that sucks capital out of the private sector. They should also put parents, teachers, and local communities back in charge of education. Rolling back the regulatory state and restoring a true free market is the way to make America great.

[48] Exports contribute to more than 20% of U.S. Farm Income | Wisconsin Ag Connection

[49] President Trump still won a majority of the farmer vote even though farmers did suffer from his first term trade policies and should have nitrated several jars for the second. See GRAPHIC: Trump support grew in America's top farming counties despite first-term trade war - Investigate Midwest