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Protectionism: As American as Apple Pie?

Paul D. Snitzer

psnitzer@prudentmanagement.com



From February 25 to March 6, 2018, negotiators from the United States, Mexico and Canada met in Mexico City for the seventh round of talks over “NAFTA” – the North American Free Trade Agreement. These talks, of course, are an initiative of the Trump Administration, following up on candidate Trump’s promise to renegotiate and improve the United States’ trade regime.

President Trump made plain during the campaign and after taking office that he viewed US trade policy as flawed and against the American tradition of protecting US industries through higher tariffs. For example, in February 2017, during his first nationally televised address to Congress, President Trump invoked none other than Abraham Lincoln, the redeemer President, as a supporter of protectionist policies. President Trump quoted an 1847 remark by Lincoln warning that the “abandonment of the protective policy by the American government... will produce want and ruin among our people” and argued that “Lincoln was right — and it’s time we heeded his advice and his words.”

Is President Trump correct that protectionism – the policy of seeking ‘to protect’ US industry by increasing the cost of foreign goods through higher tariffs – is a core part of the American tradition? If so, is it a wise policy?

As to the first question, a recent book by Dartmouth economist Douglas A. Irwin, *Clashing Over Commerce: A History of US Trade Policy*, examines in intricate detail trade policy from 1763 to the present. Nationally known economist (and former PMA luncheon speaker) Tyler Cowen calls it “likely the best history of trade policy to be written.”

Irwin's history establishes without a doubt that for the first 140 years after the formation of the United States, policies in favor of protectionism were well within the mainstream of American political debate. Indeed, one of the earliest proponents of protective policies was Alexander Hamilton, of newfound fame, who delivered to the first Congress in 1791 his *Report on the Subject of Manufactures*. This report, described by Irwin as one of the most "influential policy documents in US history," argued that "competition upon equal terms" between US manufacturers and foreign producers "is in most cases impracticable." Accordingly, "the extraordinary aid and protection of government" is required to achieve "a successful rivalry."

Hamilton's argument was advanced in the pre-Civil War period by Henry Clay, the Speaker of the House for 12 years, and a man who Lincoln eulogized in 1852 as his "beau ideal of a statesman." Although Clay did not use the term "America first," he did advocate for a "genuine American policy" that would "counteract the policy of foreigners, and withdraw the support which we now give to their industry, and stimulate that of our own country."

Despite these arguments, however, Irwin's history shows that up until the Civil War, primarily because the export driven South adamantly opposed protectionist policies, the tariff was set at a rate solely to generate income to fund the federal government (tariffs were the primary revenue source for the federal government during this period) and was not set at a higher rate for the purpose of protecting domestic industries.

During the Civil War, however, the tariff was increased dramatically and repeatedly to raise revenue for that effort, and after the war, with the South devastated and, for a period, disenfranchised, there was no political force advocating for a return to pre-war tariff levels. The period from 1865 to 1930, therefore, might be viewed by President Trump as the "golden period" of American protectionism. Not only did tariffs remain high as a result of the Civil War increases, but Republican governments, acting explicitly under the mantle of protectionism, enacted yet further tariff increases in 1890, 1897 and 1922.

Then, in 1930, Republicans enacted, even after the stock market crash of 1929, the infamous Smoot-Hawley tariff, an enactment that proved devastating to the protectionist movement. Smoot-Hawley was initially sold as a bill to protect farmers, but farmers in 1929 were suffering from low prices and high debt, problems not remedied by increases to the tariff. The Republicans, however, by opening the door to interests seeking protection, lost control of the legislative process, which became unseemly, and ended with a bill containing a "mind numbing" level of detail that specified tariff rates on just under 3,300 items. World reaction, to the surprise of many Republicans, was negative and some of the US largest trading partners, such as Canada, responded with strong retaliatory measures.

In short, Smoot-Hawley was a debacle, and its timing, at the onset of the Great Depression, created a "widespread perception" that it "was at least partly responsible for the economic disaster." Politically, it "helped rejuvenate the dormant low-tariff wing of the Democratic party" which wing was soon to gain an unprecedented unified control of the government for 14 years, from 1932 to 1946. During this period President Roosevelt and the Democratic Congress fundamentally changed US trade policy by delegating to the Presidency vast powers to negotiate with foreign countries and to reduce tariffs as part of those negotiations. By 1940 the US had signed agreements with 21 nations, which caused the average tariff to drop to pre-Smoot-Hawley levels. WWII then "caused many Republicans to shed" the isolationist and pro-tariff views they had held which marked another "major shift" in US international policy. Accordingly, by 1950 the average tariff had fallen to 13%, the lowest levels since 1791.

While trade policy did become more contentious during the 1970s and 1980s, the enactment of NAFTA (a 2000 page agreement) in December 1993 was a great bi-partisan achievement. Although President Clinton's administration had not negotiated NAFTA (most of its negotiation occurred under President George H.W. Bush), President Clinton supported the law and it was enacted in Congress only because it achieved large Republican support in the House of Representatives, where it was opposed by the majority of Democrats. Subsequent to the enactment of NAFTA, trade between the US and Mexico/Canada increased from 290 billion annually to 1.1 trillion. Canada is the largest export market for US goods and agriculture, and the total volume of trade between Canada and the US almost equals US trade with China. After Canada, Mexico is the next largest export market for US producers. Finally, according to statistics maintained by the Office of the United States Trade Representative, the US runs a trade surplus with Canada, not a deficit.

In summary, therefore, President Trump is correct that protectionist policies have a place in American history, but those policies have not been in favor for the past 85 years, a period of great growth and prosperity for the American people as a whole.

As to the second question posed at the beginning of this letter - is a high tariff good policy - as the above makes clear, that is a contentious issue that has been disputed since the beginning of the Republic. However, the consensus amongst the professionals at PMA is that it is not.

The tariff, by explicitly seeking to increase the cost of a product, is in the nature of a tax on consumption, a regressive form of tax, hitting lower income people harder than higher income.

While it is true that open trade can cause real hardship on workers in industries subject to harsh foreign competition, economist Russ Roberts of Stanford University's Hoover Institute conducts a fascinating thought experiment about job loss in his article "*The Human Side of Trade*" (see inserts). Roberts asks us to imagine a foreign company inventing a pill that enables all humans to live without illness/disease until age 120, thereby solving the problem of human sickness and health related suffering. But, if this pill is imported it will cause the elimination of the millions of jobs in all hospital, pharmaceutical and insurance industries. Should we allow this import? Roberts' explanation for why the answer is "yes" is surprising and worth reading.

Finally, as Adam Smith pointed out, the "propensity to truck, barter and exchange one thing for another" is "nothing more than human nature", i.e., no other species has evolved the systematic exchange of goods and services, especially over great distances, that humans currently engage in and have engaged in from the dawn of civilization. Interfering with the settled expectations that underlie this irreducible and primal human impulse, is of necessity a fraught endeavor subject to numerous pitfalls and unintended consequences.

While PMA will not, of course, make investment decisions based on a prediction of the outcome of the current negotiations, we will continue to monitor these matters and to hope that President Trump's aggressive rhetoric proves to be more of a negotiating tactic than a desire to upend the last 85 years of trade policy.