IDEAS ON LIBERTY
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A Tale of Two Tariffs

by Larry Schweikart

Although it doesn't happen often, especially with modern "econometric" tools and the application of computers, sometimes there are questions in recent economic history where those who embrace free markets *know* something is right but just can't prove it. We can argue theory endlessly, but some people are never convinced until you show them a little empirical proof.

Such is the case of the tariff in American history, particularly two key episodes: the early "protective tariff" established in George Washington's day and the Smoot-Hawley Tariff, whose role in sparking the Great Depression has been asserted but never proved. Until quite recently, free-market advocates have had to rely on theory to advance the position that those tariffs were at best unnecessary and at worst destructive. But scholars continue to look for new topics, and better ways of investigating the topics they have. The result is a series of new studies that shed light on these two critical chapters in American tariff history.

First, the basics: a tariff is a tax on imports. Since the United States of America has a government, even the most minimalist "Jeffersonian" government needs money to carry out its functions, and it must come from some source. In the early Republic, where the Founders despised direct taxes, George Washington's administration, led by Secretary of the Treasury Alexander Hamilton and Secretary of State Thomas Jefferson, settled on two main sources to avoid direct taxation: a tariff and land sales. Hamilton's argument on the tariff was that it would raise revenue and "protect" infant American industries against the more established competition from Great Britain. Thus it was known as a "protective" tariff.

Although the dean of tariff historians, Frank Taussig (1931), contended that this tariff ceased to protect after the 1830s, he lacked the computing tools and masses of data now available to back up his claims.[1] Nor could he say much about the early period, when he, like most other economists and historians, agreed that the tariff had indeed "protected" American manufacturers. Over the next 60 years the so-called liberal drift of academe tended to gently repudiate Taussig. Then in 1984 Mark Bils and C. Knick Harley wrote articles in the *Journal of Economic History* arguing that the tariff was absolutely necessary even after the 1830s for the survival of American manufacturing.[2]

Fortunately, that was not the last word. Douglas Irwin and Peter Temin detected a major flaw in previous analyses of the supposed benefits of tariffs in the early Republic, namely: the analysts always assumed that American producers would make the same things as their British competitors. This, of course, was a complaint by free marketeers for some time, but on a slightly higher level.

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It went something like this: if the British were more competitive in textiles than American manufacturers, then Americans would simply have made other products or specialized more in agriculture, like, say, New Zealand. This line of thinking ironically played into the hands of the protective-tariff crowd, who then pointed out all the "spillover" effects of the textile industry that were not present in agriculture. Textile manufacturing techniques influenced virtually all other early American production, and management structures spread to almost all other businesses.

Thus it might be argued that the United States would have become a substantial agricultural exporter, but it would have been more difficult to see how the nation could have achieved industrial greatness. That, in turn, would have undercut a basic free-enterprise argument that no matter who has a head start, anyone can catch up through hard work and the infusion of talent and energy. If the United States never could have caught up to England without the tariffs, there might be a case for the old "rich-getting-richer" argument.

Thankfully, that is not the case. In the September 2001 issue of the *Journal of Economic History*, Irwin and Temin demonstrate that earlier scholarship on the tariff was most likely wrong because of flawed assumptions. Rather than competing in the same types of cloths, British and American producers made different types of textile products that were, as the authors say, "imperfect substitutes" for one another.[3] In fact, the authors found, the "U.S. cotton-textile producers were not dependent upon the tariff" by the 1830s, and they conclude that the industry could have survived even if the tariff had been eliminated. Simply put, Irwin and Temin discovered that Americans did not try to compete head-on with the British at the outset, but rather immediately identified their "comparative advantage" in cheaper cloths.

Although Irwin and Temin nearly shut the door on the tariff debate, they did leave a small crack: The period from 1816 to 1830, when the textile industry first took off, was arguably the most critical time, the point where tariffs would have their maximum effect. But that argument has its own problems. First, the data stinks, colloquially speaking, for that 14-year span. Second, Thomas ("small-government") Jefferson embargoed all exports to Britain in 1808, meaning that from that time until the end of the War of 1812 (ostensibly the Treaty of Ghent, ratified in 1815), there was no competitive free market anyway.

What about the post-war period? Separating any effects of the tariff from other economic dislocations of the day is difficult, mainly because of the nationwide depression that began in 1816 that is generally associated with a spate of inflationary bank-note issues. Textile producers, seeing a flood of British imports when their own mills were in trouble due to the Western currency collapse, "could not do anything about the general economic slump, [but] they could try to stop imports."[4] Thus they appealed to Congress for tariff protection. It is likely that this sole remaining 14-year "window" will become the subject of new econometric studies to determine the impact of the tariff, but if the current trend in scholarship is any indicator, the pro-"protective tariff" crowd will not be happy with the results.

Al Gore vs. Ross Perot, Part Deux

The second tariff that has come under scholarly scrutiny recently is the Smoot-Hawley Tariff of 1930, which was viewed as being linked to the Great Crash, and therefore the Great Depression, on the basis of circumstantial evidence in Jude Wanniski's book *The Way the World Works*.[5] This tariff, raising rates even higher than the earlier Fordney-McCumber Tariff, increased duties on almost all imports. But on some extremely important raw materials, key to the manufacturing sector, the rates soared by more than 30 percent. According to Wanniski, Smoot-Hawley passed critical points in the congressional committee system just prior to the Crash. He ties the successes of the tariff, and its setbacks, to drops and surges in the stock market. Wanniski produces no smok-

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ing gun, but argues that the crucial vote occurred on October 28, 1929, when the tariff bill cleared its final committee hurdle. Claiming that industries engaged in predictable defensive responses at the inescapable tax, Wanniski argues that they laid off employees, raised prices, and reduced production. Another likely response not claimed by Wanniski is that companies (which are often their own largest stockholders) would have naturally dumped their own securities on the open market in an attempt to get liquid.

Although Wanniski is an accomplished economist, he is no academic, and thus his theory was pigeonholed as that of a "pop" economist with no real data—until quite recently. Once again, tariff historian Irwin has provided answers that "go where no man has gone before."[6] In several studies he found that the tariff reduced imports 4–8 percent in nominal terms, but when deflationary effects are factored in, the real decline attributable to Smoot-Hawley may have accounted for a fourth of the 40 percent decline in imports after 1930.[7]

So what? say some economists. After all, the impact of Smoot-Hawley on the total trade of the United States still only represented a small share of output. How could changes in the terms of trade, no matter how dramatic, affect the entire economy? In fact, as Mario Crucini and James Kahn show, the changes in trade had a ripple effect, in which the Smoot-Hawley Tariff *alone* could have reduced the U.S. GNP by 2 percent in the 1930s. To put things in perspective, most economic historians have assessed the impact of the railroads on the nation's economic growth at 5 percent.[8] Or, in other words, the Smoot-Hawley Tariff in two or three years took away half the growth that the railroads added in 50! And, like Irwin, Crucini and Kahn found that the Fed's deflationary policy—which some libertarians have wedded to the notion of a Fed *inflation* in the 1920s—made the Smoot-Hawley Tariff much worse.

Irwin, Crucini, and Kahn have not only provided the evidence that the Smoot-Hawley Tariff was phenomenally damaging, but that when combined with the Fed's monstrous deflation so adeptly outlined by Milton Friedman, it became a true two-headed hydra. The only question remaining is Wanniski's original allegation that anticipated passage of the tariff bill sparked the Great Crash, and once again, we have new research to suggest that it did. In the 1990s Robert Archibald and David Feldman found that the politics of the Tariff generated tremendous business uncertainty. That uncertainty started in 1928 and grew worse throughout 1929 as the Tariff marched forward. Archibald and Feldman come as close as anyone has to linking the Smoot-Hawley Tariff specifically to the Great Crash.[9]

Where once free marketeers had only good sense, general theory, and a little history on their side, a new wave of econometric studies has now established that tariffs did not protect anything after 1830; that they likely did not protect much before 1830; and that the Smoot-Hawley Tariff was one of the most destructive pieces of economic legislation ever written. □

1. Frank W. Taussig, *The Tariff History of the United States*, 8th ed. (New York: G. P. Putnam's Sons, 1931).
2. Mark Bils, "Tariff Protection and Production in the Early U.S. Cotton Textile Industry," *Journal of Economic History*, December 1984, pp. 1033–45, and C. Knick Harley, "International Competitiveness of the Antebellum American Cotton Textile Industry," *Journal of Economic History*, September 1992, pp. 559–84.
3. Douglas A. Irwin and Peter Temin, "The Antebellum Tariff on Cotton Textiles Revisited," *Journal of Economic History*, September 2001, pp. 777–98.
4. Ibid.
5. Jude Wanniski, *The Way the World Works: How Economies Fail—and Succeed* (New York: Basic Books, 1978).
6. Irwin provided a good overview of all trade policy in light of tariffs in his book *Against the Tide: an Intellectual History of Free Trade* (Princeton: Princeton University Press, 1996).
7. Douglas A. Irwin, "The Smoot-Hawley Tariff: A Quantitative Assessment," *Review of Economics and Statistics*, May 1988, pp. 326–34; "Change in U.S. Tariffs: The Role of Import Prices and Commercial Policies," *American Economic Review*, September 1988, pp. 1015–26; and "From Smoot-Hawley to Reciprocal Trade Agreements: Changing the Course of U.S. Trade Policy in the 1930s" in Michael D. Bordo, Claudia Goldin, and Eugene N. White, *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century* (Chicago: University of Chicago Press, 1988), pp. 325–52.
8. Mario J. Crucini and James Kahn, "Tariffs and Aggregate Economic Activity: Lessons from the Great Depression," *Journal of Monetary Economics*, 38 (1996), pp. 427–67, and Crucini, "Sources of Variation in Real Tariff Rates: The United States, 1900–1940," *American Economic Review*, June 1994, pp. 732–43.
9. Robert B. Archibald and David H. Feldman, "Investment During the Great Depression: Uncertainty and the Role of the Smoot-Hawley Tariff," *Southern Economic Journal*, 64 (1998), pp. 837–79.

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We're All Rawlsians Now!

by Robert A. Lawson

In the 1970s Richard Nixon famously remarked, "We're all Keynesians now." Fortunately, the president overestimated the long-run influence of John Maynard Keynes's ideas among economists. For modern philosophers, it might be appropriate to rephrase Nixon's line and say, "We're all Rawlsians now."

John Rawls, the Harvard University philosophy professor, truly has had as much influence in philosophy as Keynes did in economics. As with Keynes, it remains to be seen if Rawls's ideas will remain in vogue in the generations to come or if he is destined to a marginal role in the history of philosophy.

John Rawls asked a simple question, "What makes for a just society?" The problem in figuring out if society is just or not is that we all already live in society, and we know, roughly, how we are going to fare in it. Rich people, pretty people, and smart people are naturally going to be inclined to say that their society is just, while poor, ugly, and dimwitted people are more likely to think society is unjust. So simply asking people what makes a society just won't work.

This is where the creative mind of Rawls comes in. He asks us to engage in a thought experiment. Let us imagine that we could wear a "veil of ignorance" that would block out all knowledge of our future condition in society. That is, imagine that we could not know whether we would be rich or poor, pretty or ugly, smart or dimwitted, white or black, or whatever. Then and only then, Rawls concluded, could we get people to decide in an unbiased way what a just society should look like.

To carry things along a bit more, Rawls even speculates on how people, all of whom are behind this veil of ignorance, would conceive of a just society. His speculation, which has inspired thousands of disciples in philosophy and elsewhere, is that rational people would consider a society just if it maximized the standing of the least well-off. This has become known as the maxi-min hypothesis: a just society maximizes the minimum person's welfare. Let us leave aside the question of whether the maxi-min hypothesis is what we would all agree to behind the veil of ignorance. Instead we will consider the implications of the maxi-min hypothesis, assuming it is correct.

Simple followers of Rawls have argued that the maxi-min hypothesis calls for income equality, but such is not the case. Rawls himself acknowledges that income inequality is allowable if it is a means for improving the status of the lowest rungs of society.

As an example, consider two societies. Society A has three people with $1,000 each—perfect income equality. Society B has

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