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TRADE WAR

Political economics: To tariff or not to tariff

By Jim Flinchum

Tariffs are combat weapons for economic warfare. Super-strategist Steve Bannon says we have long been in an economic war with China. Other weapons include quotas, forced technology transfer, intellectual property violations, partiality in regulatory administration, etc. All are used by China against us.



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Tariffs never make other nations happy, as it is usually a win-lose struggle. When we impose tariffs, the nations that export to us are the losers, as their sales to us normally decrease. Additionally, our consumers lose because they pay some portion of the increased costs of tariffs.

Historically, tariffs were initially used as a revenue raiser, before becoming protective of "infant industries." Now, they are also used for "national security" or political purposes to encourage or to bludgeon nations into agreement with us.

The Constitution was adopted in 1788, but it did not permit Congress to impose taxes. For revenue, Congress had to sell land or beg from the states, which was insufficient. Strictly to raise revenue, Congress imposed our first tariffs on imports the following year. It

was not used to protect any U.S. industry nor used as a political weapon. It was strictly to raise revenue.

Initially, the tariff rates remained modest, until Congress increased the rates in 1828, upon which riots broke out in the South, especially South Carolina, where it was called the "Tariff of Abominations." Southerners didn't think it was funny or patriotic to pay higher prices for imports. Northerners generally favored high tariffs, while Southerners did not.

Starting at only 5% in 1789, tariffs averaged about 20% on all imports until 1913. Tariffs got as high as 95% – imagine 95% tariffs – before the federal income tax was approved in 1913. America is no stranger to tariffs!

The leading U.S. politician in favor of establishing tariffs was our first secretary of the treasury, Alexander Hamilton. Most economists don't like tariffs, as the burden to pay at least some portion of the increased cost falls on the consumer. (Some portion of the increased costs usually decreases the sellers' profit margin.) Furthermore, tariffs distort prices in the supply chain.

International economists generally don't like tariffs, as they interfere with the principle of comparative advantage, which shows all countries benefit when each country makes whatever product has a comparative advantage.

For example, France shouldn't try to compete with Iceland producing salted white fish, while Iceland shouldn't try to compete with France producing wine.

Left alone, market forces will efficiently determine which country produces which product. Tariffs interfere with that efficiency.

The absence of tariffs is usually called "free trade." Americans routinely genuflect upon hearing the term free trade, but it does not always work out successfully.

Africa is an example. It is largely without tariffs but has been losing ground economically for years. Its share of world GDP has dropped by 50% over the last 50 years. There's more to economic growth than just tariffs.

In comparison, a major reason for the success of China is its use of tariffs to protect its own industries. The U.S. has also done this. As recently as 2002, we imposed a 30% tax on imported steel, just to protect our steel industry. (Remember steel dumping?)

Historians have traditionally taught the Smoot-Haley Act of 1930 made The Great Depression both inevitable and worse. Economists, however, teach us the act was only partially responsible for the depression. They point out U.S. GDP dropped a stunning 26% even though international trade was only 9%

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of GDP. Therefore, something else must have contributed.

Also, most of our GDP decrease was from 1930 to 1932, before most of the Smoot-Haley provisions were even effective. Regardless, Smoot-Haley did not help and may well have made things worse.

There is legitimate historical argument tariffs can strengthen the economy. Between 1871 and 1913, tariffs averaged almost 38% in the U.S., while GDP grew an impressive 4.3% annually – more than twice as fast as free trade countries at the time. Could history repeat itself? Of course, but there were other reasons for our good GDP growth those years besides tariffs.

Our GDP growth rate in the first quarter of this year was a relatively robust 3.1% as buyers loaded up on imports before tariffs became effective. While it is too early for second quarter GDP growth rate to be published, most economists think the economy has slowed somewhat.

What would it take to get us back to a 4.3% GDP growth rate? More than higher tariffs, I'm afraid.

The president may have noticed the country enjoying the greatest success in modern history with imposing tariffs and other protectionist measures is, Russia, which imposed tariffs on food imports in 2013. Food imports dropped dramatically, workers rioted, but Russian food producers multiplied.

Today, Russia is food self-sufficient. While its experience with tariffs was very positive for Russia, note their tariffs were protectionist, designed to protect certain national industries.

They were not political or designed to bludgeon other nations.

One little-noticed problem of the current trade war is increased uncertainty, which dampens economic growth, as well as the stock market.

When first announced, I was worried the president had launched a war, hopefully just a trade war. History provides multiple examples of trade issues leading to shooting wars, especially when egos are involved. I have also been worried about fighting the war on so many fronts. In addition to China, trade deals with Mexico and Canada are not yet sealed, plus the president has promised tariffs against Europe, particularly their auto companies.

Who's next? Vietnam? Fighting everybody all of the time is not prudent.

Make no mistake – trade wars are a last resort. China has abused the World Trade Organization guidelines for decades. Diplomacy and negotiation were tried unsuccessfully. China left us with no alternative to a trade war. I wish the president great success but pray he starts no more wars of any type.

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