The Cycles of U.S. Trade Policy

By Jay Foraker

The United States was born a resource-rich exporting colony of the United Kingdom, generating federal revenues and protecting infant industries through tariffs on imports in the decades following its founding. Although tariff rates had fallen by the onset of the Civil War, the Union’s need to fund the war effort and the removal of opposition from Southern states in Congress began a period of relatively high tariffs that lasted until shortly before World War I, when they were lowered in conjunction with the introduction of a federal income tax.

Tariffs were once again raised in the 1920s, but a key inflection point was the Tariff Act of 1930, also known as the Smoot-Hawley Tariff. Smoot-Hawley represents a high-water mark for tariffs, after which the U.S. took a leading role on the world stage in reducing tariffs globally and creating a legal framework for resolving trade disputes via the General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO).

In this article, we reflect on the evolution of U.S. trade policy, specifically as it pertains to tariffs, and highlight lessons learned from key events, including Smoot-Hawley.¹

¹This article provides a historical overview of U.S. trade policy. For more details on how trade changes could affect today’s economy, read Chief Investment Strategist Scott Clemons’ first quarter 2017 InvestorView article, “The Economy and Markets in the Time of Trump.”
U.S. Tariffs in the 18th and 19th Centuries

At the nation’s founding, U.S. trade policy was decidedly protectionist, characterized by high levels of import tariffs compared with the present day.

The first federal tariff was enacted in 1789; as early as 1795, Treasury Secretary Alexander Hamilton’s Report on Manufactures encouraged protection of young “infant” industries in the new nation from more developed foreign competitors. Soon thereafter, in the early 19th century, Sen. Henry Clay of Kentucky advocated a system of industrial development in the United States underpinned by the imposition of tariffs on imports.²

Yet the early republic was divided – decisively along regional bounds – over the issue of import tariffs. Generally speaking, Northern industrialists supported tariffs to protect a burgeoning domestic manufacturing sector, while Southern agricultural interests opposed them. The Tariff of 1828 (or “Tariff of Abominations,” as it was known to Southern opponents) starkly revealed schisms of the era. It allowed average tariff rates to rise to approximately 60% on most imports and contributed to the Nullification Crisis of 1833, in which South Carolina voted to nullify federal tariffs. The result was the Compromise Tariff of 1833, which gradually lowered federal tariffs over time.³

Opposition to tariffs grew along ideological, in addition to regional, lines. This included those who opposed tariffs because of the resulting federal revenue surpluses, which caused contention over what to do with said surpluses.³

The advent of the Civil War largely shifted the contours of the debate as Southern representatives left Congress following secession and the voice of surplus opponents softened as the costs of waging the war shrank the surplus. The Civil War ushered in a high-tariff era that lasted until the early 20th century.

The newly formed Republican Party led by President Lincoln campaigned on a high-tariff platform in 1860, partly to gain support from Eastern industrialists. Following the party’s electoral victory, the Morrill Tariff was passed in 1861, which was the first in a long series of tariff increases that lasted until the early 20th century.⁴

U.S. Tariffs in the Early 20th Century

Tariffs were the primary source of federal tax revenues until the Progressive Era of the early 20th century. At this time, various forces – including the maturing of domestic manufacturing industries and the fact that the U.S. populace was beginning to push back against tariff-induced price increases – led to a shift away from tariffs and toward an income tax for raising revenues.

³ Ibid., p. 158.
to fund the federal government. Resulting was the 1913 ratification of the 16th Amendment to the Constitution allowing for a federal income tax, along with the passage of the Underwood Tariff Act instituting a federal income tax and gradually lowering basic tariff rates from 40% to 25% under Democratic President Woodrow Wilson.\(^5\)

Following World War I, the U.S. returned to a high-tariff policy under the Fordney-McCumber Tariff of 1922. Key drivers of this were military costs from the war, the emergence of new infant industries (e.g., chemicals) viewed as needing protection and a desire to protect domestic agriculture production. This return to high tariffs, however, had two negative consequences: difficulty for Europe to export to the U.S. and thereby recover financially from the war, as well as subsidizing U.S. agricultural overproduction.\(^6\) These factors are frequently cited as contributors to the Great Depression.

### The Smoot-Hawley Tariff of 1930

The origins of the Smoot-Hawley Tariff can be traced to the 1928 presidential campaign, during which Republican candidate Herbert Hoover campaigned on a platform of alleviating the plight of the U.S. farmer. Again, as many economists and historians have cited, a central agricultural problem in the 1920s was overproduction.\(^7\)

Following Hoover’s victory and the control of both houses of Congress by his party, additional industries came before Congress and pleaded for protection, with the result being the Smoot-Hawley Tariff of 1930, which introduced the highest average tariff rates since the 1830s.\(^8\)

Both Sen. Reed Smoot (R-Utah and Senate Finance Committee chair) and Rep. Willis Hawley (R-Oregon and House Committee on Ways and Means chair) hailed from predominantly rural, agricultural states. As such, the act initially had a special focus on agriculture. However, following the 1929 stock market crash and act’s passage in June 1930, its scope expanded to include over 900 imported agricultural and non-agricultural products and raised average tariff rates to nearly 60%.\(^9\)

There was strong opposition to the Smoot-Hawley Tariff at the time. A letter signed by more than 1,000 economists was presented to President Hoover opposing the act. Further, Thomas Lamont, who was J.P. Morgan’s deputy at the eponymous Morgan Bank, recalled that in 1930 “I almost went down on my knees to beg Herbert Hoover to veto the asinine Hawley-Smoot Tariff. That Act intensified nationalism all over the world.”\(^10\)

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\(^5\) Ibid., p. 329.


Statistically speaking, the impact of Smoot-Hawley was stark. In the year following the crash of October 1929, which includes the enactment of Smoot-Hawley:

- Industrial production fell 30% in the United States, 25% in Germany and 20% in the United Kingdom.
- Five million people became unemployed in the United States.
- Commodity prices collapsed 50% globally, including coffee, wheat and cotton.

Other objective measures of Smoot-Hawley’s effect include the following:

- The nominal value of global trade dropped from $36 billion in 1929 to $12 billion in 1932.
- The value of U.S. exports fell from $5.2 billion in 1929 to $1.2 billion in 1932.
- The rate of bank failures in the U.S. began to accelerate.

While there is disagreement around the degree to which Smoot-Hawley contributed to the Great Depression, the consensus is that it had some impact.

There are several perspectives to the debate. First, although the act is widely cited as an example of bad policy, there is disagreement as to its actual impact and significance. Highlighting direct damage caused by Smoot-Hawley, economists Paul Krugman and Maurice Obstfeld contend that “major economic harm was done by restrictions on international trade and payments, which proliferated as countries attempted to discourage imports and keep aggregate demand bottled up at home” and that Smoot-Hawley “had a damaging effect on employment abroad.”

To the contrary, author Liaquat Ahamed contends that far more damaging than the protectionist Smoot-Hawley Act was the collapse in capital flows in 1930, specifically the slowdown of U.S. foreign investment in Europe. He also points out that exports were a relatively small share (4%) of U.S. GDP at the time, and as such, changes in capital flows would have dwarfed changes in trade flows, and the impact of tariffs would have been relatively limited. In addition, U.S. tariffs were already at relatively high levels historically in the 1920s.

Second, Smoot-Hawley illustrates what can happen when trading partners react to an elevated tariff. Following its enactment in June 1930, retaliatory measures were introduced by Italy, France, Canada, Cuba, Mexico, Australia and New Zealand. Even Switzerland retaliated against the higher tariffs on Swiss watches contained in the act. The U.K.’s response was to institute an “imperial preference system” that raised tariffs in an

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14 Ahamed. Lords of Finance, pp. 375-376.
effort to keep trade within the British Empire. In sum, Smoot-Hawley had the result of raising domestic welfare by worsening conditions abroad. Such a policy is known as a “beggar thy neighbor” policy. For this reason, the act is frequently cited as a quintessential example of a zero-sum policy choice. Per Charles Kindleberger, Smoot-Hawley was a mistake for both economic and psychological reasons “less for its impact on the United States balance of payments, or as conduct unbecoming of a creditor nation, than for its irresponsibility” because it led to a “headlong stampede to protection and restrictions” worldwide.

Third, U.S. tariffs have not returned to Smoot-Hawley levels since the 1930s; in fact, U.S. trade policy has decidedly changed course. The 1933 London Economic Conference failed in achieving a multilateral solution to Smoot-Hawley and other retaliatory tariffs. Indeed, there was short-term evidence that “save your own neck” policies were working. As the Great Depression worsened, however, a major shift in U.S. trade policy occurred in 1934 with the passage of the Reciprocal Trade Agreements Act, which authorized the Roosevelt administration to negotiate trade agreements reducing tariffs bilaterally. Thirty-one such agreements were completed in the following decade.

The 1944 Bretton Woods Agreement initially envisioned, alongside the World Bank and International Monetary Fund (IMF), the establishment of the International Trade Organization (ITO) to facilitate the multilateral reduction of tariffs. Interestingly, the ITO was never established, largely due to U.S. political opposition, but can be seen as a forerunner to the WTO.

### Conclusion

After Smoot-Hawley and the close of World War II, the U.S. turned decidedly in the direction of free trade – that is, reducing tariffs, a trend that rippled throughout the industrialized capitalist countries.

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20. Ibid., p. 21.
Beginning in 1947, the GATT convened and progressively reduced tariffs among its members over the course of eight subsequent rounds of discussions, ending in 1994. Members initially included industrialized countries but later expanded to other emerging economies.  

Later, in 1995, the U.S. played a leading role in establishing the current legal framework of the WTO, under which member countries agree to the most-favored nation principle for trading with other member countries and have a system of recourse through which to channel disputes.

Statistically, the move toward a low-tariff policy post-1945 for the U.S. appears to have been a positive move:

- Global trade increased by a factor of six in the 15 years following World War II.
- In 2000, the value of global trade was 125 times its 1950 level, equaling $7.5 trillion annually.

Nonetheless, the debate over tariffs and the relative merits of protectionism vs. free trade continues today. However, lessons from the past – particularly of Smoot-Hawley – loom large in this debate. A central lesson is the inherently unpredictable reaction of trading partners. What degree of retaliation would follow a country’s unilateral imposition of higher tariffs? The WTO permits certain recourse against countries that unfairly raise tariffs, but are the costs of retaliation worth the benefits of domestic industry protection?

These considerations highlight the fact that policy decisions involve choice, choice sends a message, and trading partners’ reactions to this message may be costly and difficult to control.

Brown Brothers Harriman has been active in the international trade finance business for nearly 200 years and has observed many cycles. We continue to monitor the evolution of U.S. and international trade policy and will keep our clients apprised of any changes and their potential economic impact.

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21 Ibid.