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Historical Perspectives on U.S. Trade Policy

Douglas A. Irwin*

In the wake of the contentious debate over the North American Free Trade Agreement and the Clinton administration's failure to obtain fast-track negotiating authority from the Congress, there are growing fears that domestic political support for liberal U.S. trade policies may be waning. It remains to be seen, however, whether globalization will unleash forces that will further erode the postwar bipartisan consensus in favor of an open trade regime and shift policies onto a more protectionist track.

The renewed debate over the future direction of U.S. trade policy, however, provides an opportune moment to reexamine the history of those policies. In a series of recent papers, I have explored the historical evolution of U.S. trade policy to investigate the role of protectionist policies in America's past and to understand the origins of the move toward a more liberal trade policy stance since World War II.

A Tariff Laffer Curve?

The Civil War marked the beginning of a long period of high U.S. tariffs. These tariffs served the dual purpose of raising revenue for the federal government and keeping out foreign goods, ostensibly for the protection of U.S. labor and business. After the war, tariffs (which generated roughly half of government revenue) remained high to service the enormous debt burden that resulted from the war. Yet by the mid-1880s a

curious problem had arisen: though much of the debt had been paid off, federal revenues were outstripping expenditures by as much as 50 percent.

Republican and Democratic politicians agreed that the fiscal surplus should be reduced, but they proposed exactly the opposite policies for achieving this objective. Democrats advocated cutting tariff rates in an effort to reduce revenue. Arguing that this would simply encourage imports and raise even more revenue, Republicans proposed higher tariff rates to reduce fiscal revenue. This debate over the tariff "Laffer curve" essentially hinged on whether existing tariffs were above or below the revenue-maximizing rate, which in turn depended on the height of the tariff and the price elasticity of import demand. My estimates of these parameters indicate that the average tariff was below its revenue-maximizing rate; therefore, a tariff reduction would have been an appropriate policy for reducing revenue. Evidence from the McKinley tariff of 1890 supports this finding.¹

Voting to Protect Infant Industries?

The tariff was an important, and highly partisan, political issue during the late nineteenth century. Republicans supported high protective tariffs and Democrats endorsed moderate tariffs for revenue purposes only. This partisan conflict came to a head in what became known as the Great Tariff Debate of 1888. After President Grover Cleveland devoted his entire State of the Union message to an attack on high tariffs, the presidential campaign of 1888 was contested primarily on the tariff issue. Cleveland won more popular votes than his Republican rival, Benjamin Harrison, but Harrison received more electoral

votes; as president, he signed the McKinley tariff of 1890. Although political historians stress that ethnic and religious factors determined electoral behavior during this period, I find that state voting patterns are more consistent with constituent economic interests. Because cotton accounted for one third of U.S. exports, cotton-producing states voted overwhelmingly for the Democrats. The Republicans drew their electoral support from Northern states, which were home to many import-competing manufacturers.²

The United States rapidly industrialized during this high-tariff period and for the first time became a net exporter of manufactured goods. Were high tariffs responsible for the growth of manufacturing since they protected infant industries from foreign competition? The tinplate industry often has been singled out as the best practical example of infant industry protection. Unlike most other manufacturers, tinplate producers did not receive significant protection after the Civil War, and the United States did not produce tinplate for most of this period. After receiving protection in 1890, however, the industry grew rapidly and U.S. prices soon fell below those prevailing in Britain, previously the major source of consumption.

My analysis of this proposed infant industry explicitly considers the counterfactual: What would have happened to the tinplate industry in the absence of protection? My results suggest that, without protection, the United States would have seen domestic tinplate production about a decade later anyway because of the fall in the domestic price of iron and steel inputs, which comprised almost two thirds of tinplate production costs. The earlier failure of the tinplate industry was attributable to the negative effective protection resulting

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from high tariffs on iron inputs, which severely compromised the competitive position of prospective producers. Dynamic scale economies in the form of learning by doing, by contrast, appear limited. To the extent that learning economies existed, they spilled over easily from Britain through the migration of skilled labor. A tinplate tariff would have been a fourth-best industry policy to offset the distorted domestic price of iron inputs, but the actual tariff applied was not optimally set and thus reduced economic welfare.³

Smoot-Hawley and the Great Depression

Although Democrats introduced a brief period of lower tariffs in 1913 (along with an income tax to create a revenue alternative to the tariff), Republican protectionism reemerged after World War I when high tariffs were imposed again. The tumultuous interwar years were marked by the excesses of protectionism and a later shift toward free trade.⁴ The Smoot-Hawley Act of 1930, perhaps the most infamous tariff in U.S. history, raised import duties to high levels on the eve of the Great Depression. Contrary to many assertions, however, Smoot-Hawley accounted for only a small part of the large decline in U.S. trade in the early 1930s. Smoot-Hawley raised the average tariff from 40.7 percent to 47 percent, roughly a 20 percent increase in rates, which translates into just a 5 to 6 percent increase in the relative price of imports. Using estimates of the price elasticity of U.S. import demand for this period, I conclude that the initial Smoot-Hawley duties were responsible for a 4 to 8 percent decline in import volume, a small part of the observed 40 percent decline.⁵

However, most of the Smoot-Hawley tariffs were specific, not ad valorem, duties. The steep price deflation after 1930 significantly

raised the ad valorem equivalent of the Smoot-Hawley duties, and by 1932 the average tariff on dutiable imports reached nearly 60 percent. When this deflationary effect on tariffs is taken into account, the higher effective tariff explains nearly one quarter of the observed drop in imports in the early 1930s.

In joint work with Randall S. Kroszner, I have also investigated the political factors behind the passage of Smoot-Hawley. Several previous studies examined Congressional voting patterns on the Smoot-Hawley tariff; they concluded that, because the final House and Senate votes were almost straight "party line," it was simply a partisan matter. In contrast, we examine the numerous Senate roll call votes on tariff rates for individual commodities. We find that votes for higher tariffs were not strictly the result of partisan factors, but were related to nonpartisan log-rolling (or vote trading) among different economic interests.⁶ This supports the contention that the institutional structure of Congressional decisionmaking was biased in favor of protection-seeking interests, thus resulting in relatively high tariffs.

From Isolationism to Internationalism

If Congress was inherently biased in favor of high tariffs, how did the United States achieve trade liberalization? U.S. trade policy began an initial shift toward a more open stance after the traditionally moderate-tariff Democrats gained control of the legislative and executive branches in 1933. In 1934, the Democrats enacted the Reciprocal Trade Agreements Act (RTAA), an important piece of legislation that set the stage for current U.S. trade policy. The RTAA allowed the president to negotiate tariff-reduction agreements with other countries without obtaining Congressional approval (although

the RTAA itself required periodic renewal). Under the authority of the RTAA, the executive reached numerous bilateral trade agreements in the late 1930s and, in the immediate postwar period, negotiated the General Agreement on Tariffs and Trade (GATT), which remains the principal framework of the world trading system today.⁷

Because ultimate authority over trade policy still resided with Congress, however, the shift toward trade liberalization was not secure until the traditionally protectionist Republicans could be persuaded to support the RTAA. Republicans consistently rejected the RTAA through the 1930s, but began to change their position in the mid-1940s. In joint work with Kroszner, I have investigated the reasons for the shift. We find that it came not from an ideological change in favor of a liberal trade policy, but from a new configuration of constituent economic interests and changes in institutional incentives arising from the RTAA.⁸ After World War II had eliminated competition from many foreign producers, domestic manufacturers supported trade agreements to obtain access to foreign markets. The RTAA itself also shifted the political balance of power toward export interests at the expense of import-competing interests. By directly tying lower foreign tariffs to lower domestic tariffs, the RTAA encouraged exporters to organize politically to oppose high tariffs and support international trade agreements.

Higher Prices, Lower Tariffs

The use of specific duties in the U.S. tariff code (referred to earlier) played an important role in bringing about the postwar tariff reductions. In the century after the Civil War, import price fluctuations had important effects on the ad valorem equivalent of those duties. Between 1865

and 1967, according to my estimates, a 10 percent increase in import prices would reduce average tariffs by about 6.5 percent. Deflation served to increase tariffs in the early 1930s, and substantial inflation during and after World War II served to erode specific duties. I find that three quarters of the decline in average tariffs between 1932 and the early 1950s—when tariffs fell from nearly 60 percent to almost 10 percent—was attributable to higher import prices.⁹

The lower postwar U.S. tariffs usually are attributed to cuts in tariff rates resulting from negotiations undertaken as a result of the RTAA, principally the GATT, which was formed in 1947. Yet these results suggest that only a small fraction of the tariff decrease came as a consequence of bilateral and multilateral trade negotiations. The importance of the GATT and the agreements it has fostered cannot be measured in terms of reducing U.S. tariffs, perhaps, but in strengthening the vested interests that have a stake in perpetuating open trade policies. The GATT has provided an institutional means of giving stability and credibility to such policies by making their reversal more costly.¹⁰

The postwar period has been marked by a broad, bipartisan consensus in favor of trade liberalization, which only recently has shown signs of fraying. Just as the creation of an open trading system depended on changes in underlying economic interests and the institutional framework in which those interests were played out, any unraveling of that system will depend on those same factors.

¹ D. A. Irwin, "Higher Tariffs, Lower Revenues? Analyzing the Fiscal Aspects of the 'Great Tariff Debate of 1888,'" NBER Working Paper No. 6239, October 1997; published in *Journal of Economic History*, 58 (March 1998), pp. 59–72.

² D. A. Irwin, "Voting for Protection? Tariff Politics and the Presidential Election of 1888," NBER Working Paper, forthcoming.

³ D. A. Irwin, "Did Late Nineteenth Century U.S. Tariffs Promote Infant Industries? Evidence From the Tinplate Industry," NBER Working Paper No. 6835, December 1998.

⁴ For an analysis of the impact of interwar preferential trade arrangements on world trade, see B. Eichengreen and D. A. Irwin, "Trade Blocs, Currency Blocs, and the Reorientation of World Trade in the 1930s," *Journal of International Economics*, 38 (February 1995), pp. 1–24.

⁵ D. A. Irwin, "The Smoot–Hawley Tariff:

A Quantitative Assessment," NBER Working Paper No. 5509, March 1996; published in *Review of Economics and Statistics*, 80 (May 1998), pp. 326–34.

⁶ D. A. Irwin and R. S. Kroszner, "Logrolling and Economic Interests in the Passage of the Smoot–Hawley Tariff," NBER Working Paper No. 5510, March 1996; published in *Carnegie Rochester Conference Series on Public Policy*, 45 (December 1996), pp. 176–200.

⁷ D. A. Irwin, "From Smoot–Hawley to Reciprocal Trade Agreements: Changing the Course of U.S. Trade Policy in the 1930s," NBER Working Paper No. 5895, January 1997; published in *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century*, M. D. Bordo, C. Goldin, and E. N. White, eds. Chicago: University of Chicago Press for the NBER, 1998.

⁸ D. A. Irwin and R. S. Kroszner, "Interests, Ideology, and Institutions in the Republican Conversion to Trade Liberalization, 1934–1945," NBER Working Paper No. 6112, July 1997.

⁹ D. A. Irwin, "Changes in U.S. Tariffs: Prices or Policies?" NBER Working Paper No. 5665, July 1996; published as "Changes in U.S. Tariffs: The Role of Import Prices and Commercial Policies," *American Economic Review*, 88 (September 1998), pp. 1015–26.

¹⁰ D. A. Irwin, "The GATT's Contribution to Economic Recovery in Post-War Europe," in *Europe's Postwar Growth*, B. Eichengreen, ed. New York: Cambridge University Press, 1995.

Equity Flows, Banks, and Asia

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After World War II, capital markets in different countries were almost completely segmented from each other. Individual investors generally could not buy securities in other countries because they could not acquire the correct currency. Since

then, dramatic changes have occurred. Currencies typically are convertible and most major obstacles to capital flows among developed countries have been removed. This evolution has allowed equity investors to invest in most countries in the world.

Unfortunately, throughout history, periods with limited barriers to international investment were followed by periods with stronger restrictions. Since the devaluation of the Thai baht last year, many countries have faced economic difficulties; many

economists and policymakers have argued that the so-called "Asian flu" has spread too far and too decisively. Led by fears of contagion and encouraged by some prominent economists, some countries, for example Malaysia, have taken measures recently to restrict capital flows. Though fixed exchange rates can breed speculative attacks and contagion, we should not forget that countries benefit from open equity markets. There is little evidence that the presence of foreign equity investors will lead to irrational move-

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