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HOW TO WIN A TARIFF WAR: SURRENDER!

by Gary North

It is naught, it is naught, saith the buyer: but when he is gone his way, then he boasteth (Prov. 20:14).

There are a lot of supposedly free market capitalists who sing the praises of open competition, but when the chips are really down, they call for the intervention of the monopolistic, coercive State in order to keep Americans from trading with other Free World countries. Competition is advocated for Americans inside the geographical boundaries of the United States. Competition is seen as a "good thing." It is seen as liberating for American consumers. Yet the benefits of competition are denied if Americans trade with certain foreigners, if Americans are buying more of their goods from these certain foreigners than these foreigners are buying from Americans. Competition is good, unless American producers are being outperformed by foreign producers: here is the cry of the tariff advocates. If there is a temporary imbalance of trade with a particular nation, American politicians start calling for sales taxes (tariffs) on imports from that foreign nation. Why? To "save American jobs."

What is an imbalance of trade? It is a situation in which a particular nation's residents are earning more dollars by selling goods and services to American residents than Americans are earning of that nation's currency by selling goods and services to its residents. And what do the foreigners do with these excess dollars? It is simply horrible. They invest them, or sell them to other nations' citizens who want to use them to invest in America, or buy goods from America, or visit America.

Politicians neglect to mention these "horrible" uses of dollars held by foreigners. They keep yelling about the trade imbalance. They keep warning U.S. voters about the devastation that is taking place to the U.S. economy. You know: the devastation of an upward stock market as foreigners buy U.S. stocks, and the devastation of a booming U.S. tourism industry. "Something must be done!" And that "something" is a tax hike, for tariffs are sales taxes.

The fact that only about 15% of our economy is directly involved in foreign trade never phases these tariff enthusiasts: free trade supposedly is "destroying" the other 85% of the American economy! Somehow, the principles of capitalism operate only within national boundaries. Somehow, the intervention of the State will "protect" Americans.

Henry Hazlitt's classic little book, *Economics in One Lesson*, completely destroys the arguments of the tariff supporters; still, they keep coming. For two centuries their position has been intellectually bankrupt; still, they keep coming. Tariffs hurt all consumers except those on the public dole of tariff intervention, e.g., the "infant industries" such as inefficient steel producers or inefficient textile manufacturers. Yet the advocates of tariffs promise that all Americans will be

"protected." The logic of economics cannot seem to penetrate otherwise rational minds.

Ignorance Is Sometimes a Blessing

This fact bothered me for many years. How could men use the arguments of the free market against "those dirty Commies" and "those dirty fascists," and still argue for tariffs? Are they simply corrupt men, arguing to keep their suppliers competitive but their competition screened out? I have finally come to a conclusion which professional economists will reject as utter superstition. The apparently indomitable, though economically erroneous, arguments favoring tariffs are a part of God's overall curse of the Tower of Babel (Gen. 11). As He divided the language of the rebellious, unified culture, as He scattered them over the face of the earth, so He may have implanted a basic hostility to economic unification through free trade into the minds of most people, at least for this present era. It keeps men divided during an era when the world's leaders are attempting to create a humanistic one-State world.

Long-term economic ignorance is in some way a part of His restraint of rebellious secular cultures. In short, the arguments favoring tariffs have a similar function in God's universe as the lying prophets He sent before Israel as the curse of the nation (Ezek. 14). He may be deliberately blinding men's eyes (cf. Isa. 6:9-11; Matt. 13:10-15). This is no excuse for becoming a lying prophet, however.

I may be seeing too much of God's hand in the failure of economists to convince men of a simple, basic fact of economic reality, but the thought has comforted me at those times when "conservatives" have tried to tell me how much they appreciate free enterprise, and how much we need tariffs against Japanese imports. When His kingdom fully arrives in history, those arguments will finally cease. Trade wars will cease, but perhaps only in those days when shooting wars cease.

"Common sense economics" is a phrase used to describe the economic reasoning of the proverbial man in the street. In many instances, this knowledge may rest on principles that are essentially correct. For example, we have that old truism that there are no free lunches. On the other hand, not all of the widely held economic beliefs are even remotely correct; some of these convictions are held in inverse proportion to their validity. The tariff question is one of these. It has been since the days of mercantilist economics (1650-1776).

The Balance of Trade

In pre-capitalist days, economists believed that nations could experience permanent "favorable" balances of trade. A favorable balance was defined as one where you sold more goods abroad than you imported, thus adding to the

national gold stock. Wealth was defined primarily in terms of gold (a position which, even if fallacious, makes more sense than the contemporary inclination to define wealth in terms of indebtedness). A generation prior to the publication of Adam Smith's *Wealth of Nations* (1776), Smith's friend, the philosopher David Hume, disposed of the mercantilist errors concerning the balance of trade. His essays helped to convert Smith to the philosophy of classical liberalism. Hume's essay, "Of the Balance of Trade," was published in 1752 in his *Political Discourses*; it established him as the founder of modern international trade theory.

The Price Rate Effect

His early arguments for free trade still are valid today. Hume focused on the first one, which is designated in modern economic terminology as the price rate effect. As the exported goods flow out of a nation, specie metals (or foreign currency credits) flow in. Money becomes more plentiful. Prices therefore tend to rise in the nation "suffering" the surplus of exports over imports.

The converse takes place in the foreign country: its specie goes out as imported goods come in, thus causing domestic prices to fall. Foreign buyers will then begin to reduce their imports in order to buy on the now cheaper home markets; simultaneously, consumers in the first nation will now begin to export specie (or foreign currency holdings) and import foreign goods. A long-run balance of trade is the result.

The Exchange Rate Effect

Hume also presented an argument called the exchange rate effect. We live in a world trading community in which we have free floating exchange rates in the international currency markets. The free market establishes the price of each currency in relation to any other. In order to purchase domestic goods, foreigners must have a supply of the exporting nation's domestic currency. As demand for the imported goods continues, the available supply of foreign currency units drops lower. Importing foreigners competitively bid up the price of the exporting nation's currency, so that it costs more and more to obtain the foreign currency necessary to buy the foreign goods. This will discourage some of the importers, who will not be able to compete. Consumers who were ready to buy imported goods at the older, lower prices now turn to their own markets. The "imbalance" of trade disappears, but without government intervention or government favoritism.

Where we find government-fixed currency exchange rates (price controls on money), the same bidding process exists, but competition is revealed in different ways. As demand rises for the sought-after foreign currency, one of two things will happen: 1) black markets in the heavily demanded foreign currencies will be established secretly, with higher prices prevailing than the government has declared, thereby reducing imports; or else 2) some kind of government-imposed quota restrictions on buying the foreign currency units will be imposed, thereby reducing the availability of the most sought-after currencies. Some domestic importers will be allowed to buy the foreign currency, but not all of the potential importers. Some importers will simply not be able to obtain all the currency they want at the official price. This subsidizes certain importers at the expense of others. This also reduces imports. The "imbalance" of trade disappears, but with government favoritism of certain groups.

Thus, what we witness is a competitive process in the exchange of goods; there can be no long-run imbalance of trade. No nation can continue to export more than it imports forever. Yet politicians and inefficient domestic producers continue to get a hearing from voters when they call for tariffs on foreign nations that are "running a surplus of

trade," as if such a surplus could continue forever unless called to a halt by politicians. Unless they impose taxes, we consumers will be harmed irreparably, they tell the voters.

Tariffs Are Discriminatory Sales Taxes

A tariff is a special kind of tax. It is a tax paid by importers for the right to offer foreign-made products for sale on a domestic market. Indirectly, however, the tax creates economic burdens for a whole host of people, but these people are seldom even aware that the tax is the cause of their problems.

Let me say from the beginning that sales taxes are paid primarily by owners of the firms on which the tax is imposed. Except in rare and uncertain circumstances, the taxed industries cannot "pass along the tax to the consumer," as is often argued. If price hikes were that easy, then the businesses would have raised prices earlier and pocketed the money.¹ Consumers ultimately set prices, not businessmen.

Who Pays?

Nevertheless, the imposition of the tax has many unrecognized economic consequences. Let us consider those in the United States. One group affected adversely by a tariff is that made up of consumers who actually purchase some foreign product. Some of them pay a higher price than would have been the case had no duty been imposed on the importer. Another consumer group that is harmed is the one that now buys an American product at a high price which is protected by the tariff. Were there no tariff, the domestic firms would be forced either to lower their prices or to shift to some line of production in which they could compete successfully. Then there is the nonconsumer group that would have entered the market had the lower prices been in effect; their form of the "tax" is simply the inability to enjoy the use of products that might have been available to them had the State not intervened in international trade.

Others besides the consumers pay. The importer who might have been able to offer cheaper products, or more of the products, if there had been no tariff, is also hurt. His business is restricted, and he reaps fewer profits. All those connected with imports are harmed. Yet, so are exporters. They find that foreign governments tend to impose retaliatory tariffs on our products going abroad. Even if those governments do not, foreigners have fewer dollars to spend on our products, because we have purchased fewer of theirs.

A second consideration should be those who are hurt abroad, although we seldom look at those aspects of tariffs. Both foreign importers and exporters are hurt, for the same reasons. The fewer foreign goods we Americans buy, the fewer dollars they have to spend on American goods and services. This, in turn, damages the position of foreign consumers, who must restrict purchases of goods that they otherwise might afford. This leaves them at the mercy of their own less efficient producers, who will not face as much competition from the Americans, since the availability of foreign exchange (U.S. dollars) is more restricted.

The tariff, in short, penalizes the efficient on both sides of the border, and it subsidizes the inefficient. If we were to find a better way of providing "foreign aid" to other countries, we might provide them with our goods (which they want) by purchasing their goods (which we want). That would be a noninflationary type of aid that would benefit both sides, rather than our present system, which encourages bullies in our government and creates resentment abroad.

Who Wins?

Two groups are obviously aided. The inefficient domestic producer is the recipient of an indirect government subsidy,

1. Murray Rothbard, *Power and Market: Government and the Economy* (Menlo Park, California: Institute for Humane Studies, 1970), pp. 66-70.

so he reaps at least short-run benefits. The other group is the State itself; it has increased its power, and it has increased its revenue. (It is conceivable to imagine a case where higher revenues in the long run result from lower tariffs, since more volume would be involved, so we might better speak of short-run increases of revenue.) We could also speak of a psychological benefit based on ignorance, but I hesitate to count it as a positive effect. This time, the public's ignorance is not a blessing.

Competition vs. Monopoly

The heart of the contradictory thinking concerning tariffs is in the statement, "I favor open competition, but . . ." Being human, men often will appeal to the State to protect their monopolistic position on the market. They secretly favor security over freedom. The State steps in to honor the requests of certain special interest groups—which invariably proclaim their cause in the name of the general welfare clause of the Constitution—and establishes several kinds of restrictions on trade.

Tariffs, trade union monopolies, and fair trade laws are all praised as being safeguards against "cut-throat" competition, i.e., competition that would enable consumers to purchase the goods they want at a cheaper price—a price which endangers the less efficient producers who must charge more in order to remain in business. The thing that most people tend to overlook in the slogan of "cut-throat competition" is that the person whose throat is slashed most deeply is the solitary consumer who has no monopolistic organization to improve his position in relation to those feared by statist intervention.²

People are remarkably schizophrenic in their attitudes toward competition. Monopolies of the supply of labor are acceptable to most Americans; business monopolies are somehow evil. In both cases, the monopolies are the product of the State in the market, but the public will not take a consistent position with regard to both. The fact that both kinds operate in order to improve the economic position of a limited special interest group at the expense of the consumers is ignored. Business monopolies are damned no matter what they do. If they raise prices, it is called gouging; if they cut prices, it is cut-throat competition; if they stabilize prices, it is clearly a case of collusion restraining free competition. All forms may be prosecuted. No firm is safe.

The way for governments to reduce the growth of monopolies is to allow new producers to enter the market and make consumers a better deal. But this would mean freedom, and far less power for government regulators. It would mean a reduction in their power. They resist such a suggestion. They want to set the terms of trade.

Competition Is a Substitution Process

The idea of competition as a cut-throat process is misleading. There are cut economic throats, no doubt. When a consumer chooses to buy one product rather than all the others on the market, he is quietly "cutting the throats" of millions of producers. Of course, he is not exactly cutting their throats; it is more like needling them. But if enough consumers decide independently that a particular firm's products do not meet their requirements, that firm has its throat cut.

The firm blames its nearest competitor. "We were the victims of unfair competition," the loser's managers assert. They blame their most successful rival for their trouble. But the real culprits are the consumers, who voluntarily chose the rival's products. The rival was simply meeting the demands of consumers. The rival asked the consumers to substitute its products on their shopping list for the products offered for sale by the loser.

Competition is a substitution process. Each consumer wants sellers to serve him, at a price he is willing to pay, rather than serve some other consumer. "Sell it to me!" the buyer says. And the seller's response is always: "What's in it for me? Why should I sell it to you? Make me a better deal."

Each seller wants buyers to buy from him, at a price he is willing to accept, rather than buy from some other producer. "Buy it from me!" the seller says. And the buyer's response is always: "What's in it for me? Why should I buy it from you? Make me a better deal."

The decision to buy and sell is always a decision to **exclude**. It is a decision to **substitute**. A person substitutes one purchase for all the other possible purchases he might be able to afford. If he is a buyer of goods, he substitutes the purchased good for all the goods and services he might have purchased, as represented by the money the purchase has cost him. There is no escape from this process of substitution. **Life itself is a series of substitutions.** Each person is constantly exchanging one set of circumstances for another set. He substitutes one situation for another.

What the defender of tariffs is implicitly arguing is that it is immoral or at least detrimental to "the national economy" for consumers to have offered to them millions of new possible substitutions. Consumers of a particular geographical region will be permitted to make the decision to substitute products and services that are produced in that region, but they are restricted from substituting products produced outside the region. They are allowed to exchange one set of circumstances for others, but not as many others as would be made available if there were no barriers to entry to the regional market.

In effect, consumers are told that some substitutions are "unpatriotic," while others are "patriotic." Politicians, under pressure from producers' lobbying groups, then decide which kinds of substitutions are legally unpatriotic. "Trust us," they say. "We know what we're doing." They are doing plenty—doing to the consumer what they claim monopolists do: cutting their throats.

Competition Is a Discovery Process

Competition is also a discovery process. Consumers discover which products they prefer, and producers discover what consumers prefer, as well as what rival producers are doing to meet consumer demand.

The process of discovery is curtailed by tariffs. Consumers are told that they are not going to be allowed to discover if certain goods meet their needs. Certain kinds of discoveries are labeled "unpatriotic." Some sorts of discoveries are declared "off limits" to searchers.

Other kinds of discoveries are classified as immune from legislative restriction. Ideas are usually classified as immune from legislative infringement. Those groups that profit from the sale of "natural monopolies"—intellectuals, professional journalists, etc.—have lobbied effectively to keep their sales markets unrestricted. Language barriers tend to serve national intellectuals well: these are God-imposed import restrictions. So intellectuals do not face "foreign ideas" to the same degree that computer manufacturers face foreign computers. Thus, intellectuals can more safely declare their domestic monopoly free from interference by "outsiders," namely, legislators. But other monopoly-seeking traffickers in the sale of discoveries—businessmen—seek to keep the market limited from foreigners, and they are willing to submit to national legislators, even though legislators are also "outsiders" to their industry.

And once allowed to enter as "protectors," the legislators decide to stay a while. They enjoy restricting discoveries in many ways besides tariffs. The regulated economy takes a giant step forward, once the "outsiders" are invited to reduce the threat of foreign competition. It is not surprising that the

2. Gary North, "Cut-Throat Opportunities," *The Freeman* (June 1982).

monopoly-seeking trusts of the Progressive Era (1900-1912) were defenders of tariffs, government-mandated price floors, and a controlled market in general.³ The price competition of capitalism was making too many new discoveries available to American consumers.

Tariffs and the Great Depression

Jude Wanniski devotes a considerable portion of Chapter Eight of his book, *The Way the World Works* (Basic Books, 1978), to the relationship between the falling stock market of 1930 and Senate debate over the Smoot-Hawley tariff. The threat of high tariffs drove down the stock market, and vice versa. It is generally recognized today by economists that the imposition of the Smoot-Hawley tariff made the depression much worse.

Why did the politicians vote for tariffs at the beginning of the great depression? Because during times of recession or depression, politicians fear that certain domestic industries will not be favored when consumers buy from abroad. This was the case under the infant neo-mercantile philosophies so popular in the 1930's. Prof. Robbins commented in 1934: "The interests which, in times of prosperity, find it hard to enlist support for their conspiracies to rob the public of the advantages of cheapness and the division of labor, find a much more sympathetic hearing."⁴

The great depression was accompanied by a wave of tariff hikes in most of the Western nations, with reduced efficiency and economic autarky as a direct result. Domestic manufacturers cry for protection from foreign producers. What they are crying for with equal intensity is protection from the voluntary decisions of their own nation's domestic purchasers; it takes two parties to make a trade, and protection from one is equally protection from the other.

The effect of tariff wars is reduced efficiency through a restriction of international trade. Adam Smith, in the opening pages of *Wealth of Nations*, presents his now famous argument that the division of labor is limited by the size of the market. Reduce the size of the market, and you reduce the extent of the division of labor. The cry for protection should be seen for what it is: a cry for a reduction in efficiency.

In a country like the United States, where less than 15 percent of our national income stems from foreign trade, the cry is especially ludicrous. We hurt the other nations, whose proportion of international trade to national income is much higher (West Germany, Japan), without really aiding very many of our own producers. But there are so few vocal interest groups representing those who benefit from freer trade, while those who have a stake in the intervention of the State make certain that their lobbyists are heard in Washington. The scapegoat of "unfair foreign competition" may be small, but being small, it is at least easy to sacrifice.

Fighting a Tariff War Successfully

When some foreign State decides to place restrictions on the importation of goods from another country, what should be the response of that latter country's economic administrators? Their goal is to make their nation's goods attractive to foreign purchasers. They should want to see the international division of labor maintained, adding to the material prosperity of all involved. If this is the goal, then policies that will keep the trade barriers at low levels should be adopted. Instead, there is the tendency to adopt retaliatory tariff barriers, thus stifling even further the flow of goods. This is done as a "warning" to other nations.

If the 1930's are anything like representative years of such warnings, then we should beware of conventional tariff wars. In those years a snowballing effect was produced, as

each nation tried to "out-warn" its neighbor in an attempt to gain favorable trade positions with all others. The result was the serious weakening of the international specialization of labor and its productivity. At a time when people wanted cheaper goods, they imposed trade restrictions that forced prices upward and production downward.⁵ Professor Mises' old dictum held true: when a State tries to improve economic conditions by tampering with the free market, it usually succeeds in accomplishing precisely the results which it sought to avoid (or officially sought to avoid, at any rate).

The best policy for "retaliation" would be to drop all tariff barriers in response. A number of things would result from such action. For one thing, it would encourage the importation of the goods produced by the offending country. Then the two effects described earlier would go into operation: the price rate effect and the exchange rate effect. The offending foreign nation would find that its domestic price level would rise, and that its citizens would then be in a position to buy more foreign goods (including the goods of the discriminated country).

If the U.S., as the injured party, continued to make it easy for our citizens to buy their goods, we would provide foreigners with lots of extra paper money and credits. What would be done with the currency or credits in the hands of citizens of the high tariff nation? They could not easily spend the dollars in their nation. They could invest the dollars here, or sell the dollars to other foreigners, or buy U.S. goods despite the tariffs. More likely, they would invest in the U.S., for they could see our commitment to increased trade, meaning greater productivity. Meanwhile, U.S. consumers would gain the use of the imported consumer goods, and we would be losing only money. Americans would be getting the best possible goods for our money, so U.S. consumers should not complain. Furthermore, because consumers have sent money abroad, U.S. consumer prices would tend to go down, making U.S.-produced goods more competitive on the international markets.

If we were to impose retaliatory tariffs, American consumers would have to settle for domestically produced goods of a less desirable nature (since our voluntary consumption patterns are restricted by the imposition of a tariff). Prices in the U.S. would remain higher because U.S. dollars stay in the hands of U.S. consumers. But what potential consumers want is goods, not money. They are forced to keep money, or else forced to buy U.S. goods that were not their first choice. They lose freedom, and pay higher prices for this "privilege."

The best way to fight a tariff war is to keep reducing tariffs until they fall to zero. It is also the best way to win the peace. By fighting the tariff war this way, U.S. consumers get more goods, and foreigners get pieces of paper with our Presidents' pictures on them. Sooner or later, foreigners will also surrender, unless foreign consumers have a very peculiar attachment to pieces of paper with U.S. Presidents' pictures on them.

Conclusion

A tariff is a self-defeating device. The statist tariff war is irrational. Its promoters argue that because a few of their nation's citizens are injured by some restriction on foreign trade, the best solution is to impose additional restrictions on foreign trade, so that far more citizens will be injured. It is a contemporary manifestation of the old cliché, "he cut off his nose to spite his face." It is time that we accept the implications of David Hume's two-hundred-year-old arguments. The best way to overcome restrictions on trade, it would seem, is to establish government policies that encourage people to trade more.

3. Gabriel Kolko, *The Triumph of Conservatism* (New York: Free Press of Glencoe, 1963).

4. Lionel Robbins, *The Great Depression* (London: Macmillan, 1934), p. 65.

5. Wilhelm Röpke, *International Economic Disintegration* (London: Hodge, 1942), ch. 3.