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The Deliberately Forgotten History of Trade

WE SAW IN THE PREVIOUS CHAPTER why the theory of comparative advantage, the key justification economics offers for free trade, is a dubious construct. But if this is so, then economic history should reflect this fact. That is, successful economic powers should have prospered by defying this theory's recommendations, not by following them. This indeed turns out to be the case. But while it is widely known that economically successful nations like China and Japan have little use for free trade even today, what is less well understood is that even the nations that have historically *championed* free trade—the most important being Britain and the United States—have not actually practiced it for most of their history. Instead, they have long, successful, but *deliberately forgotten* records as protectionists.

Standard economic history taught in the United States is distorted by ideology and has key facts airbrushed out. That history, largely a product of Cold War myth-mongering about the virtues of pure free markets, attributes world economic growth to the spread of free markets to one nation after another, aided by free trade between them. Not only do free traders believe in this history, but it pretty much *has to be* true if the economics of free trade is valid. But economic history actually reveals that no major developed nation got that way by practicing free trade. Every single one did it by way of protectionism and industrial policy.

Industrial policy? That's the deliberate manipulation of the *domestic* economy to help industries grow. Although this is a book about protectionism, from this point on we will not be able to ignore industrial policy entirely. Industrial policy is inextricably bound up with protectionism because these two policies are just the domestic and foreign expressions of the same underlying fact: *100 percent pure free markets are not best.* So it is almost impossible for protectionism to be right without some kind of industrial policy being right, too. And because the mechanisms of effective protectionism are important largely for what they make happen *inside* the industries that make up an economy, understanding industrial policy helps illuminate what makes protectionism work.

One can, of course, always dismiss history as a guide to economic reality. In fact, this is precisely what contemporary economics, which is highly ahistorical, generally does.[400] It is impossible to run real controlled experiments in economics, as one can in the physical sciences, because this would require re-running history with alternative policies. Therefore one can always claim that nations which succeeded under protectionism would have succeeded without it. One can even claim that they succeeded in spite of, not because of, their protectionism, and that protectionism held them back.[401] But such criticism is empty, as it makes *any* economic claim logically immune to historical evidence. One can only let the history below speak for itself, and see what looks like the least tendentious and most plausible interpretation of the generally agreed facts.

THE GREAT BRITISH FREE-TRADE MYTH

According to the creation myth of free trade, Great Britain is the original motherland of free markets, home of Adam Smith and David Ricardo both, the first nation to break free of the misguided gold-hoarding mercantilism that came before and consequently the industrial superpower of the 19th century, erector of a global empire upon free-trade principles. As Britain was indeed a free-trading state for most of this period, this myth has surface plausibility. Among other things, the British themselves believed in it during their mid-19th-century economic zenith. Some of them still do: the British newsmagazine *The Economist* was founded in 1843 specifically to agitate for free trade, and does so today from airport newsstands on six continents.[402]

Unfortunately, this whole story depends upon tricks of historical timing and starts to fall apart once one gets a few dates right. Adam Smith published his epoch-making free-trade tract *The Wealth of Nations* in 1776. But Britain in 1776 was not a blank slate upon which free markets and free trade could work their magic. It was instead the beneficiary of several prior *centuries* of protectionism and industrial policy.[403] In the words of British economist William Cunningham:

> For a period of two hundred years [c. 1600-1800], the English nation knew very clearly what it wanted. Under all changes of dynasty and circumstances the object of building up national power was kept in view; and economics, though not yet admitted to the circle of the sciences, proved an excellent servant, and gave admirable suggestions as to the manner in which this aim might be accomplished.[404]

England in this era was, in fact, a classic authoritarian (this is long before English democracy)[405] developmentalist state: a *Renaissance South Korea*, with kings rather than the military dictators who ruled South Korea for most of the Cold War period. English industrialization must actually be traced *300 years* prior to Adam Smith, to events like Henry VII's imposition of a tariff on woolen goods in 1489.[406] King Henry's aim was to wrest the wool weaving trade, then the most technologically advanced major industry in Europe, away from Flanders (the Dutch half of present-day Belgium), where it had been thriving upon exports of English wool. Flemish producers were entrenched behind huge capital investments, which gave them economies of scale sufficient to outcompete fledgling entrants into the industry. So only government action could get England a toehold.

Even in the 15th century, there was an awareness that being an exporter of agricultural raw materials was a dead end—a problem African and Latin American nations wrestle with to this day. Henry VII created, in fact, the first *national industrial policy* of the modern era, long before the Industrial Revolution introduced artificial energy sources like steam power.[407] A whole interlocking series of now-forgotten policy moves underlay the rise of English industry; what all these measures had in common was that protectionism was essential to making them work. In the words of economist John Culbertson of the University of Wisconsin and the Federal Reserve Board of Governors:

> Step after step in the cumulative economic rise of England was directly caused by government action or depended upon supportive government action: the prohibition of importation of Spanish wool by Henry I, the revision of land-tenure arrangements to permit the development of large-scale sheep raising, Edward III's attracting of Flemish weavers to England and then prohibiting of the wearing of foreign cloth, the termination of the privileges in London of the Hanseatic League under Edward VI, the near-war between England under Elizabeth I and the Hanseatic League, which supported the rise of English shipping. And then there was the prohibition of export of English wool (which damaged the Flemish textile industry and stimulated that of England), the encouragement of production of dyed and finished cloth in England, the use of England's dominance in textile manufacture to push the Hanseatic League out of foreign markets for other products, the encouragement of fishing...[408]

The aim of English policy was what would today be called "climbing the value chain": deliberately leveraging existing economic activity to break into more-sophisticated related activities. Fifteenth-century England was considerably more primitive than Bangladesh is today, so, among other things, it had not yet developed sophisticated financial markets capable of systematically identifying and exploiting business opportunities. Therefore it could not count on the free market to drive its industry into ever-more-advanced activities, but required the active intervention of the state to do so. The free market does not spring into existence fully formed and functional automatically or overnight, a lesson most recently demonstrated in the chaos of post-Communist Russia.

Henry VII's advisors got their economic ideas ultimately from the city-states of Renaissance Italy, where economics had been born as a component of Civic Humanism, their now-forgotten governing ideology.[409] The name for this forgotten developmentalist wisdom of early modern Europe that has stuck is *mercantilism*. One of the great myths of contemporary economics is that mercantilism was an analytically vacuous bundle of gold-hoarding prejudices.[410] It was, in fact, a remarkably sophisticated attempt, given the limited conceptual apparatus of the time, to advance national economic development by means that would be familiar and congenial to the technocrats of 21st-century Tokyo, Beijing, or Seoul.[411]

Mercantilists invented many economic concepts still in use today, such as the balance of payments, value added, and the embodied labor content of imports and exports. They championed the economic interests of the nation as a whole at a time when special interests (notably royal monopolies) were an even bigger problem than today. They began with obvious ideas like taxing foreign luxury goods. They progressed to the idea that exporting raw materials for foreigners to process was bad if the nation could process them itself.[412] They understood that nations rose economically by imitating the industries of already rich nations (first the more primitive industries, then the more sophisticated) and that low relative wages were the key advantage of underdeveloped nations in this game.

Even mercantilists' much-mocked obsession with the accumulation of bullion was not as irrational as it is usually depicted as being, given that under a monetary system based on gold, accumulating it is the only way to expand the money supply and drive down interest rates, a boon to investment then as now.[413] Mercantilism, in fact, created the modern European economy and thus made possible the colonial power that economically shaped much of the rest of the world. It is thus the foundation of modern capitalism itself.

Anyhow: Britain functioned on a mercantilist basis for *centuries* before its much misunderstood experiment with free trade began. Even as late as the beginning of the 19th century, Britain's average tariff on manufactured goods was roughly 50 percent—the highest of any major nation in Europe.[414] And even after Britain embraced free trade in most goods, it continued to tightly regulate trade in strategic capital goods, such as the machinery for the mass production of textiles, in order to forestall its rivals. As we saw in the previous chapter, this was rational, as the win-win logic of free trade can break down if factors of production are mobile between nations (dubious assumption #4) or if free trade induces adverse productivity growth abroad (dubious assumption #6).[415] Even Adam Smith himself was only in favor of free trade *after* Britain had consolidated its industrial power through protectionism.[416]

BRITAIN'S FREE TRADE GAMBLE

Free trade in Britain began in earnest with the repeal of the Corn Laws in 1846, which amounted to free trade in food, Britain's major import at the time. ("Corn," in the usage of the day, meant all grains.) The general election of 1852 was taken for a plebiscite on the question,[417] and free trade

began inexorably to restructure the British economy from without.[418] Repealing the Corn Laws was a momentous step because this removed the last major constraint on Britain's transformation, along the lines of its then-comparative advantage in manufacturing, into the world's first industrial society, where most workers would be factory workers, not farmers: how to feed so many factory workers?

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To some extent, the objective of the Corn Laws was simply to feed a bulge in population (almost a tripling in the previous 100 years) on a small island with limited agricultural potential.[419] Competition with the prairies of North America eventually devastated Britain's old rural economy and the aristocracy that had lived off its agricultural rents,[420] but so committed was Britain to free trade that this price was accepted as in no other nation. Britain's rulers expected that free trade would result in their country dominating the emerging global industrial economy due to its head start, sidelining its trading partners into agriculture and raw materials. They expected their lead in shipping, technology, scale economies, and financial infrastructure to be self-reinforcing and thus last indefinitely.[421]

If the rest of the world had been content to be played for fools, this strategy might have worked. Instead, it enjoyed a brief window of plausibility in the 1850s and 1860s, which were the zenith of classical liberalism (of which free trade was a part) in Europe generally. Then things started to sour. For one thing, this zenith of free trade coincided with a prolonged Europe-wide depression, which started to lift as protectionism began to take hold.[422] More fundamentally, the British plan for universal free trade stumbled as the U.S. and the rest of Europe declined to accept their inferior allotted roles in the global trading system. In Germany and the United States especially, people accused Britain of favoring free trade for *other* countries and only *after* having secured its own position through protectionism. The influential German economist Friedrich List (1789-1846) called this "kicking away the ladder." As one British Lord said in Parliament:

> Other nations knew, as well the noble lord opposite, and those who acted with him, that what we meant by free trade, was nothing more nor less than, by means of the great advantages we enjoyed, to get the monopoly of all their markets for our manufactures, and to prevent them, one and all, from ever becoming manufacturing nations.[423]

So despite British preaching, free trade was falling apart. Britain practiced it unilaterally in the vain hope of imitation, but the United States emerged from the Civil War even more explicitly protectionist than before, Germany under Bismarck turned in this direction in 1879, and the rest of Europe followed. During the 1880s and 1890s, tariffs went up in Sweden, Italy, France, Austria-Hungary, and Spain.[424] There was good reason for this: they worked. A study by the Irish economist Kevin O'Rourke shows a clear correlation between protection and economic growth rates in Europe in the 1875-1914 period.[425]

FOREIGN PROTECTIONISM, BRITISH DECLINE

The United States brought to global competition continental economies of scale and a more aggressively commercial culture than Britain. Germany brought industrial paternalism that delivered an efficient workforce and a prescient understanding that science-based industry was the wave of the future, quintessentially in optics, chemical engineering, and the electrical industries. Both nations forged ahead under protectionism. Britain's economy still grew, but inexorably lagged: from 1870 to 1913, industrial production rose an average of 4.7 percent per year in the U.S., 4.1 percent in Germany, but only 2.1 percent in Britain.[426] In the melancholy words of one commentator:

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> The industries that formed the core of the British economy in the 19th century, textiles and steel, were developed during the period 1750-1840—before England abandoned mercantilism. Britain's lead in these fields held for roughly two decades after adopting free trade but eroded as other nations caught up. Britain then fell behind as new industries, using more advanced technology, emerged after 1870. These new industries were fostered by states that still practiced mercantilism, including protectionism.[427]

But despite the mounting failure of its great strategic gamble, Britain stuck to free trade abroad and a laissez-faire absence of industrial policy at home. Fundamentally, the country was lulled by the Indian summer of its industrial supremacy—it was surpassed economically by the U.S. only around 1880—into thinking that free trade was optimal as a permanent policy. The clarity of British thinking was not helped by the fact that certain vested interests had fattened upon free trade and established a grip upon the levers of power that was hard to break.

Britain's decline did not go unnoticed at the time, either at home or abroad. Neither did the underlying problem: in the 1906 words of Member of Parliament F.E. Smith, later famous as a friend of Winston Churchill:

> We give to our rivals a free market of 43,000,000 persons in the United Kingdom to add to their own free market. Thus the United States possess an open market of 82,000,000 persons in the United States, plus an open market of 43,000,000 persons in Great Britain, making, altogether, 125,000,000. Similarly, Germany possesses an open market of 43,000,000 in Great Britain. As against this, we possess only such residual of our open market of 43,000,000 as the unrestricted competition of foreign nations leaves unimpaired.... *We call ourselves free traders, but we have never secured free trade for ourselves; we have merely succeeded in enlarging the area within which our protectionist competitors enjoy free trade.*[428] (Emphasis added.)

Some British politicians set out to do something about the problem. The great crusader to abolish free trade was the Conservative Parliamentarian Joseph Chamberlain (1836-1914), father of the more famous Neville.[429] As he put it in a major speech in 1903:

> I believe that all this is part of the old fallacy about the transfer of employment...It is your fault if you do not leave the industry which is failing and join the industry which is rising. Well—sir, it is an admirable theory; it satisfies everything but an empty stomach. Look how easy it is. Your once great trade in sugar refining is gone; all right, try jam. Your iron trade is going; never mind, you can make mouse traps. The cotton trade is threatened; well, you can make mouse traps. The cotton trade is threatened; well, what does that matter to you? Suppose you tried dolls' eyes...But how long is this to go on? Why on earth are you to suppose that the same process which ruined sugar refining will not in the course of time be applied to jam? And when jam is gone? Then you have to find something else. And believe me, that although the industries of this country are very various, you cannot go on forever. You cannot go on watching with indifference the disappearance of your principal industries.[430]

The British turn-of-the-last-century debate eerily echoes the free trade debate in America today. It was an era like our own, with new technologies like the steamship and the telegraph ushering in fears of what a borderless global economy might bring. The political fate of a weakening superpower with global responsibilities was bound up in fears of its economic decline. Consider these familiar-sounding agenda items from a conference of Britain's Trades Union Congress: "the need to deal with competition from the Asian colonies" and "the need to match the educational and training standards of the United States and Germany."[431]

The same accusations made in the U.S. today flew back and forth. Free traders were accused of viewing economics solely from the consumer's point of view and of favoring short-term consumption over long-term producer vitality. Protectionist concern for producer vitality was tarred as mere cover for special interests. It was debated whether protectionism stifled competition by excluding foreigners or preserved it by saving domestic competitors (New trade theory now understands it can do either).[432] It was debated whether the country was living off its past capital. It clearly was: by the late 19th century, Britain ran a chronic deficit in goods and only managed to balance its trade by exporting services as shipper and banker to the world and by collecting returns on past overseas investments. Free traders were accused of abstractionism; in the words of one book at the time:

> The free trader hardly professes to base his opinions on experience; he is content to adduce illustrations from actual life of what he believes *must* happen.[433]

Those words could have been written yesterday! The trustworthiness of British economists, ideologically mortgaged to the free-trade tradition of classical political economy, was questioned. Free traders denied the existence of a crisis on the grounds that the nation's sunrise industries were doing well (some were, but not enough to replace the sunset industries being lost). The two sides preened themselves on their cosmopolitanism and their patriotism, respectively.

In hindsight, the protectionists had the stronger case, but were outfought by the superior rhetorical and political skill of their rivals. The vested interests and experienced political tacticians were mostly on the free-trade side—which included half of Chamberlain's own Conservative party, which split on the question. Free traders were defending a status quo bound up in concepts of economic liberty believed essential to British national identity, concepts that struck at the heart of what made Britons different from statist Continental Europeans. And free trade's opponents made no attack upon the economic theory *behind* free trade, beyond blankly denying

its validity. This made it impossible for them to construct a case against free trade strong enough to pull it up by its roots.

Chamberlain struggled to enact a tariff from 1903 to 1906, when his party fought a general election, largely on this very issue. The divided Conservatives lost to the free-trade Liberal party. Their next chance came in 1923 and they lost again, this time to the free trade Labour party. Thanks to the Great Depression, Britain finally abandoned free trade in 1931—but by then it was too little, too late. Although protectionism buffered Britain against the Depression somewhat, it was far too late to redeem the nation's position as a leading economic power. Today, outside the City of London's financial center, the one-time Workshop of the World, which generated a third of global industrial production in 1870,[434] is an economic asterisk.

AMERICA, SWEET LAND OF PROTECTIONISM

The idea that America's economic tradition has been economic liberty, laissez faire, and wide-open cowboy capitalism—which would naturally include free trade—resonates well with our national mythology. It fits the image of this country held by both the right (which celebrates this tradition) and the left (which bemoans it). It is believed both here and abroad. But when it comes to trade at least, it is simply not real history. The reality is that all four presidents on Mount Rushmore were protectionists. (Even Jefferson came around after the War of 1812.)[435] Protectionism is, in fact, the real American Way.

Americans were alert to the dangers inherent in trade economics even before Independence. During the colonial period, the British government tried to force its American colonies to become suppliers of raw materials to the nascent British industrial machine while denying them any manufacturing industry of their own. The colonies were, in fact, one of the major *victims* of Britain's previously-noted mercantilist policy, being under Britain's direct political control, unlike its other trading partners. As former Prime Minster William Pitt, otherwise a famous conciliator of American grievances and the namesake of Pittsburgh, said in Parliament, "If the Americans should manufacture a lock of wool or a horse shoe, I would fill their ports with ships and their towns with troops."[436]

To some extent, the American Revolution was, in fact, *a war over industrial policy*, in which the commercial elite of the Colonies revolted against being forced into an inferior role in the emerging Atlantic economy. This is one of the things that gave the American Revolution its exceptionally bourgeois character as revolutions go, with bewigged Founding Fathers rather than the usual unshaven revolutionary mobs. It is no accident that upon Independence, a tariff was the very second bill signed by President Washington.[437]

Protectionism's first American theorist was Alexander Hamilton—the man on the $10 bill, the first Treasury Secretary, and America's first *technocrat.* As aide-de-camp to General Washington during the Revolution, he had seen the U.S. nearly lose due to lack of capacity to manufacture weapons (France rescued us with 80,000 muskets and other war materiel.) He worried that Britain's lead in manufacturing would remain entrenched, condemning the United States to being a producer of agricultural products and raw materials. In modern terms, a banana republic. As he put it in 1791:

> The superiority antecedently enjoyed by nations who have preoccupied and perfected a branch of industry, constitutes a more formidable obstacle than either of those which have been mentioned, to the introduction of the same branch into a country in which it did not before exist. To maintain, between the recent establishments of one country, and the long-matured establishments of another country, a competition upon equal terms, both as to quality and price, is, in most cases, impracticable. The disparity, in the one, or in the other, or in both, must necessarily be so considerable, as to forbid a successful rivalship, without the extraordinary aid and protection of government.[438]

Hamilton's policies came down to about a dozen key measures. In his own words:[439]

1. "Protecting duties." (Tariffs.)

2. "Prohibition of rival articles or duties equivalent to prohibitions." (Outright import bans.)

3. "Prohibition of the exportation of the materials of manufactures." (Export bans on industrial inputs, like King Henry VII's ban on exporting raw wool.)

4. "Pecuniary bounties." (Export subsidies, like those provided today by the Export-Import Bank and other programs.)

5. "Premiums." (Subsidies for key innovations. Today, we would call them research and development tax credits.)

6. "The exemption of the materials of manufactures from duty." (Import liberalization for industrial inputs, so some *other* country can be the raw materials exporter.)

7. "Drawbacks of the duties which are imposed on the materials of manufactures." (Same idea, by means of tax rebates.)

8. "The encouragement of new inventions and discoveries at home, and of the introduction into the United States of such as may have been made in other countries; particularly those, which relate to machinery." (Prizes for inventions and, more importantly, patents.)

9. "Judicious regulations for the inspection of manufactured commodities." (Regulation of product standards, as the USDA and FDA do today.)

10. "The facilitating of pecuniary remittances from place to place." (A sophisticated financial system.)

11. "The facilitating of the transportation of commodities." (Good infrastructure.)

Hamilton set forth his case in his *Report on Manufactures,* submitted to Congress in 1791.[440] Due in large part to the domination of Congress by Southern planters, who favored free trade, Hamilton's policies were not all adopted right away. It took the War of 1812, which created a surge of anti-British feeling, disrupted normal trade, and drastically increased the government's need for revenue, to push America firmly into the protectionist camp. But when war broke out, Congress immediately doubled the tariff to an average of 25 percent.[441]

After the war, British manufacturers undertook one of the world's first well-documented cases of predatory dumping, whose purpose was, in the words of one Member of Parliament, to "stifle in the cradle, those rising manufactures in the United States, which the war had forced into existence."[442] In reaction, the American industrial interests that had blossomed because of the tariff lobbied to keep it, and had it raised to 35 percent in 1816. The public approved and by 1820, America's average tariff was up to 40 percent.[443]

Fast-forward a few years. Gloss over a number of important tariff-related political struggles, such as the South Carolina Nullification Crisis of 1832, one of the precursors of the Civil War, in which South Carolina tried to reject a federal tariff. There was a brief free trade episode starting in 1846, coinciding with the aforementioned zenith of classical liberalism in Europe, during which America's tariffs were lowered. But this was followed by a series of recessions, ending in the Panic of 1857, which brought demands for a higher tariff so intense that President James Buchanan—the last free-trade president for two generations—gave in and signed one two days before Abraham Lincoln took office in 1861.[444]

SLAVERY VS. THE TARIFF

The next big protectionist event in American history is the rise of the Republican party, spurred into being by the conflict over slavery but inheriting from its Whig party antecedent an agenda of aggressive government support for economic development. The new party favored a number of policies to this end, including hard money (deflation, the preference of creditors), subsidies for railroads, free land for homesteaders, and higher tariffs. In office from 1861, the Republicans lost no time raising tariffs, using the excuse of funding the Civil War and conveniently not having free-trade Southern Democrats in office. President Lincoln's economic guru was a Philadelphia economist named Henry Carey—forgotten in our day but world-famous in his own.[445]

It would be an exaggeration to say that the Civil War was "about" the tariff, as some Southern partisans claim, eager to shed the opprobrium of the South's having fought for slavery. But slavery and free trade are intimately connected as economic policies because free trade is, in fact, the ideal policy for a nation which actually *wants* to be an agricultural slave state. Because slaves are unsuitable for industrial work, slave states from Rome onward have failed to industrialize.[446] Because they have no hope of developing comparative advantage in manufacturing, their best move is to optimize the comparative advantage in slave-based agriculture they are

stuck with and import most everything else. Classic Ricardian free trade fits this strategy to a "t." The antebellum South, having little manufacturing industry to protect, derived little benefit from the tariff. Economically, it was still a part of the British Empire that bought its cotton, America's leading export before 1870.[447] As the tariff was the main source of federal revenue in those pre-income tax days, the South also bore a disproportionate share of the nation's tax burden. No wonder it was in favor of free trade, which the Confederate constitution eventually mandated.[448]

There is a larger lesson here, reaching beyond American history. Almost all nations that have failed to break into modern industry have a common characteristic: in terms of U.S. history, *their equivalents of the South won their civil wars*. These were not all actual wars, of course, some being merely struggles of interest-group politics, but the pattern is consistent: agricultural or raw-materials interests won a battle with rising manufacturing interests and biased the economic policy of the state in their favor. Sometimes this outcome was imposed by a colonial overlord, but it was often self-inflicted.

This pattern goes way back, predating the industrial revolution by centuries. In Spain, for example, the key moment was arguably the *Guerra do los Comuneros* of 1520-21, in which aristocratic agricultural interests, embodied in such groups as the sheep owners' organization *La Mesta*, won control of economic policy after a failed insurrection against the Habsburg monarchy.[449] So instead of protecting its manufacturing, Spain protected agricultural products like olive oil and wine. As a result, Spanish industrialization actually went backwards and Spain gradually *de*industrialized for the remainder of the century. Then came the easy pickings of New World empire, and a flood of silver and gold caused Spain to lose interest in industrialization completely. Its economy has only converged with the level of its European peers in the last 20 years.

THE GOLDEN AGE OF AMERICAN INDUSTRY

After the Civil War, tariffs stayed high during the long Republican hegemony from 1865 to 1932. Reading the speeches of 19th-century Republican politicians today, with their expressions of concern for the wages of the American working man, one finds oneself wondering how the party slipped to its present day let-them-eat-cake position. (One can dismiss these sentiments as fraud, but the tariff was real enough.) Republicans of the robber-baron era were no angels, but they did believe that American capitalism depended upon class harmony—in contrast, as they saw it, to unstable revolutionary Europe.[450] Without a significant welfare state, America had to do *something* to smooth the rougher edges of capitalism, and the tariff was a way to unite the interests of American workers and American capitalists.

The country at large generally supported this policy, though the left- and right-wing extremists of the day naturally dissented. Extreme right wing Social Darwinists like William Graham Sumner—who published a fuming book in 1885 entitled *Protectionism, the Ism That Teaches That Waste Makes Wealth*—saw protectionism as a subsidy for the incompetent and an interference with the divine justice of the free market and the survival of the fittest.[451] Karl Marx, at the other extreme, wanted to see American capitalism break down and therefore favored free trade for its destructive potential. He wrote that:

> The protective system of our day is conservative, while the free trade system is destructive. It breaks up old nationalities and pushes the antagonism of the proletariat and bourgeoisie to the extreme point. In a word, the free trade system hastens the social revolution. It is in this revolutionary sense alone, gentlemen, that I vote in favor of free trade.[452]

The Democrats of this era, who generally supported free trade, were not Marxists, of course. But they saw the tariff as either a tax on the non-industrial regions of the country (like the South, solidly agrarian and solidly Democratic during this period) or as a racket for the benefit of big business. In the 1913 words of Democratic Congressman (later the famous House Speaker) Sam Rayburn of Texas:

> The system of protective tariffs built up under the Republican misrule has worked to make the rich richer and the poor poorer. The protective tariff has been justly called the mother of trusts [monopolies]. It takes from the pockets of those least able to pay and puts into the pockets of those most able to pay. The two great parties in the long past took distinct positions upon the tariff question—the Democratic party of the masses on the one side and the Republican party of the classes on the other side.[453]

America's tariff regime in this era was not especially sophisticated. One searches the historical record in vain for complex theories about what the tariff should be or for the elaborate technocratic institutions that managed it. There were neither. Tariff policy was mostly set by not-entirely-uncorrupt Congressional logrolling. Corruption was moderated by the fact that the dealmaking was fairly public (as tariffs were considered nothing to be ashamed of), and the tariffs themselves were moderated by the fact that one industry's output was often another's input, so lobbyists seeking higher tariffs were counterbalanced by lobbyists seeking lower ones. But that's about as subtle as things got. In Sumner's annoyed words:

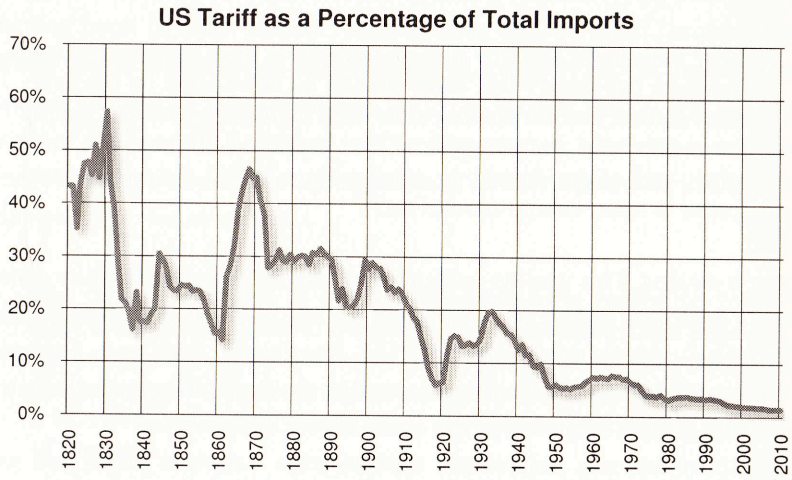
> They have never had any plan or purpose in their tariff legislation. Congress has simply laid itself open to be acted upon by the interested parties, and the product of its tariff legislation has been simply the resultant of the struggles of the interested cliques with each other, and of the logrolling combinations which they have been forced to make among themselves.[454]

But it worked. This was the golden age of American industry, when America's economic performance surpassed the rest of the world by the greatest margin. It was the era in which the U.S. transformed itself from a promising mostly agricultural backwater, pupil at the knee of European industry, into the greatest economic power in the history of the world.

About the only technocratic sophistication American tariffs had was some drift towards taxing manufactured goods more than raw materials. In part, this simply reflected the fact that raw material imports were less likely to face a competing American industry lobbying for its own protection. In 1872, keeping pace with American industrialization, Congress modified the tariff from a broad-based levy on a wide range of imports to a narrower one targeted at protecting industrial wages and manufacturing industry.[455] The U.S. went from importing five percent of its imports untaxed to nearly 50 percent; tea and coffee now came in duty-free.[456]

Protectionism was the overwhelming consensus of the era. Grover Cleveland, the sole Democratic president of the 1870-1913 period, survived politically largely by keeping quiet about the tariff. Then, after his first term in office, he ran in 1888 on a platform of cutting the tariff in favor of an income tax, devoting his entire 1887 State of the Union address to this idea. He was tarred in the press as a dupe of British interests and lost to Republican Benjamin Harrison.[457] He learned his lesson and recanted. He returned to office in 1893, the only split-term president in American history.

The chart below gives the big picture. Note that this chart does not show the average tariff on *dutiable* goods (not all goods have been dutiable), and that it masks variations by product. Note also that changes in tariffs collected as a percentage of total imports can be caused not only by changes in tariff *rates*, but also by shifting proportions of what is imported. And remember that part of the significance of a tariff is that it eliminates some imports entirely, a fact that does not show up on this chart at all.



Source: author's chart from "Merchandise imports and duties, 1790-2000," Table Ee424-430 in Historical Statistics of the United States, Earliest Times to the Present, *edited by Susan B. Carter et al. New York: Cambridge University Press, 2006, and Census Bureau and Customs & Border Protection for 2000-2010.*

AMERICA'S RETREAT FROM THE TARIFF

Contrary to what one might expect, the United States' retreat from the tariff was not caused by changes in policymakers' opinions about economics. That is, there was no point at which they decided that the economics of protectionism was false and the economics of free trade was true. Rather, this retreat was driven by essentially *political* motives, operating in a space of economic insouciance carved out by our mid-20th-century economic zenith. Fundamentally, we believed that the foundations of our economic

strength were so secure that we didn't have to worry very much anymore about what they were. And for decades after we started dismantling protectionism, the legacy effects of 150 years of it shielded us from the consequences of increasingly free trade and distorted our understanding of what those consequences really were.

Woodrow Wilson was the first modern president to believe in free trade. (It was number three of his famous Fourteen Points for Peace after WWI.) He succeeded in reducing tariffs in 1913, in the course of introducing income tax for the first time since the Civil War, but Congress pushed them back up in 1921. The Roaring Twenties were a tariff era.

The "notorious" Smoot-Hawley tariff of 1930 is sometimes blamed for all or part of the Great Depression—most recently by presidential candidate John McCain, who said during the 2008 presidential campaign:

> Every time the United States has practiced protectionism we've paid a very heavy price for it. Some even claim, with some authenticity, that the Smoot-Hawley tariff act was a major contributor to the outbreak of World War II, not to mention the Great Depression.[458]

This accusation is obviously implausible, given that the Depression was already taking hold, due to the 1929 stock market crash, before Smoot-Hawley even passed Congress. And it was proved by economist Milton Friedman (at least to the satisfaction of the Nobel Prize committee) that the Depression's cause was monetary.[459] The Fed had allowed the money supply to balloon during the late 1920s, piling up in the stock market as a bubble. It then panicked, miscalculated, and let it collapse by a third by 1933, depriving the economy of the liquidity it needed to breathe. Trade policy was not involved.

As for the charge that Smoot-Hawley caused the Depression to spread worldwide? It did not affect enough trade, or raise the tariff by enough, to have plausibly so large an effect.[460] For a start, it only applied to about one-third of America's trade: about 1.3 percent of our GDP. Our average duty on dutiable goods went from 44.6 to 53.2 percent—hardly a radical change.[461] Tariffs as a percentage of total imports were higher in almost every year from 1821 to 1914.[462] America's tariffs went up in 1861, 1864, 1890, and 1922 without producing global depressions, and the recessions of 1873 and 1893 managed to spread worldwide without tariff increases.[463]

Neither does the myth of a death spiral of retaliation by foreign nations hold water.[464] According to the official State Department report on this question in 1931:

> With the exception of discriminations in France, the extent of discrimination against American commerce is very slight...By far the largest number of countries do not discriminate against the commerce of the United States in any way.[465]

World trade declined, but almost entirely due to the Depression itself, not tariffs. "Notorious" Smoot-Hawley is a deliberately fabricated myth, plain and simple.[466] *Smoot* was a moderate and routine adjustment to America's trade regime, not a major shock to the world trading system.[467]

THE TURNING POINT ON TARIFFS

America's tariffs first started to come down for good in 1934, at the instigation of FDR's Secretary of State Cordell Hull. Hull's faith in free trade had more to do with his belief it would promote world peace than any particular economic analysis. In his own words:

> I reasoned that, if we could get a freer flow of trade—freer in the sense of fewer discriminations and obstructions—so that one country would not be deadly jealous of another and the living standards of all countries might rise, thereby eliminating the economic dissatisfaction that breeds war, we might have a reasonable chance for lasting peace.[468]

This strange quasi-Marxist view that the underlying cause of war is "economic dissatisfaction" finds little support in history. But because of it, by 1937 the U.S. had reciprocally cut tariffs with Cuba, Belgium, Haiti, Sweden, Brazil, Colombia, Honduras, Canada, Switzerland, Nicaragua, Guatemala, France, Finland, Costa Rica, El Salvador, Czechoslovakia, and Ecuador.[469] This first turn towards tariff cuts was greased through Congress by being presented as "an emergency measure to deal with emergency panic conditions," and was mostly not spotted for the historic turning point it was. Because the Great Depression and World War II interfered with normal trade, it had little immediate practical effect, and the idea of tariff

cutting was quietly assimilated to the New Deal consensus without much public ado, despite some fierce battles inside the administration.[470]

But a trend had taken root. As part of this change, Congress unconstitutionally (contra Article I, Section 8, which reads, "*Congress* shall have Power To lay and collect Taxes, Duties, Imposts and Excises [and] to regulate Commerce with foreign Nations") ceded control over tariffs to the President. FDR turned the task over to mid-level officials from the State Department and other government departments—men not even sufficiently highly placed to require Congressional confirmation.[471] Free traders have ever since preferred to keep tariffs out of the hands of Congress and in the hands of "experts" insulated from democratic accountability. Congress had previously managed the tariff with moderately corrupt favor trading and had had few ideological or geopolitical axes to grind. The Executive was also subject to interest-group politics, but it operated behind closed doors and had a far stronger tendency to make tariff policy the handmaiden of extraneous foreign policy agendas.[472]

FREE TRADE TO BEAT COMMUNISM

In the aftermath of World War II and in the face of British decline, the U.S. assumed Britain's mantle of global underwriter of free trade. In the 1947 negotiations that established the General Agreement on Tariffs and Trade, the world's main trading framework until establishment of the World Trade Organization in 1995, America cut its average tariff 35 percent.[473] It was easy to do at the time, with the U.S. running a substantial (4.2 percent of GDP) trade surplus from 1946 to 1947.[474]

This was a deliberate Cold War strategy aimed at strengthening the economies of the noncommunist world and binding them to the U.S.[475] It was obviously geopolitically wise, even if we know now that Communism was a less formidable economic challenger than it then seemed. "All problems of local industry pale into insignificance in relation to the world crisis," President Eisenhower told Congress in 1953.[476] Thus America became the only major market open to trade; all the others were small, poor, protected, socialist or communist.

At this stage of the game, American policymakers still had some residual awareness of the value of tariffs. (The delusion that free trade actually made economic sense only set in later.) Thus the Marshall Plan to deliberately reindustrialize Europe, and industrialize for the first time agricultural nations like Italy and semi-industrialized nations like France, employed high tariff walls and tight controls on capital mobility.[477] At the time, we believed not that free trade made economic sense for us, but that our superior productivity had bought us enough breathing room to engage in it for political reasons regardless.[478] As President Truman put it:

> Our industry dominates world markets...American labor can now produce so much more than low-priced foreign labor in a given day's work that our workingmen need no longer fear, as they were justified in fearing in the past, the competition of foreign workers.[479]

For 15 years or so, this was probably true. But our allies' economies had recovered from WWII by 1960. And by the end of the 1960s, world Communism's "We will bury you" threat to surpass us economically (which had genuinely worried rational people watching the USSR grow faster than the U.S. in the 1950s) had ceased to be credible.[480] So the original rationales for America's turn towards free trade had expired.

In retrospect, the early 1960s were the time America should have turned back from free trade. We certainly could have. Unfortunately, we instead made the exact same mistake Britain had made a century before and mistook the short-term advantages of free trade, when viewed from the perspective of the leading economy of the day, for permanent benefits. In the early 1960s, it certainly *seemed* as if imports were only penetrating low-end industries, giving us foreign goods on the cheap while leaving our high-value industrial sectors unharmed. This appeared to vindicate the Ricardian notion that free trade would always operate in our favor. So we let a policy with a temporary and political origin harden into a permanent economic dogma. We started to indulge the delusion that the underlying economics really *did* work.

FREE TRADE SOURS FOR AMERICA

In retrospect, John F. Kennedy's Trade Expansion Act of 1962 was America's decisive wrong turn on trade.[481] Quantitatively, the so-called Kennedy Round of tariff cuts was large enough to be noticed, but not earth-shaking: as this legislation was phased in, our average duty on dutiable imports fell from 14.3 percent in 1967 to 9.9 percent in 1972.[482] But this was one of

history's small yet decisive turning points, occurring as it did at the same moment that America's trading partners were getting into high gear economically and the 1944-71 Bretton Woods system of fixed exchange rates was beginning to falter. And tariff cuts were exceptionally steep on high technology goods, increasing their impact.[483] Furthermore, the Trade Expansion Act should be evaluated not simply in terms of its before and after tariff levels, but contrasted with the alternative of turning back from free trade, which is what we should have done.

There were certainly warnings at the time. The famous liberal economist John Kenneth Galbraith bluntly told President Johnson in 1964 that "If we are screwed on tariffs, this will have an enduringly adverse effect on the balance of payments. It will be a serious problem for years to come."[484] And, lo and behold, the first serious trade-related cracks in the American economy began to appear in the late 1960s. Black-and-white television production left for Japan. So did cameras, transistor radios, and toys. Our trade went into deficit in 1971. We have not run a surplus since 1975.[485]

There has, of course, been a simmering revolt against free trade ever since. Organized labor, which had actually *supported* the Kennedy tariff cuts when proposed in 1962, turned against free trade by the end of the decade. In 1968, Senators Ernest Hollings (D-SC) and Norris Cotton (R-NH) managed to pass a protectionist trade bill in the Senate with 68 votes. President Johnson had it killed by House Ways and Means Committee chairman Wilbur Mills.[486] 1969 saw the first consideration, by Commerce Secretary Maurice Stans, of creating an American agency to coordinate industrial policy. Nixon abandoned the effort for lack of Congressional support.[487] In 1971, a trade deficit of one-half of one percent of GDP (about a tenth of today's level) was enough to frighten Nixon into imposing a temporary 10 percent surcharge tariff on all dutiable goods.[488] In 1972, the AFL-CIO endorsed the Burke-Hartke bill, which would have imposed quotas on imports in threatened industries and restricted the export of capital by multinational corporations.[489]

But free trade survived all these challenges. Fundamentally, protectionist forces in Congress fumbled the ball. In the words of one scholar describing the failure of the big protectionist push in the last days of the Nixon administration:

> Even in Congress, protectionist industries failed to utilize their potential resources. During negotiations over general trade bills in

> Congress, protectionists exerted weak influence because they lacked an umbrella association to represent them. Instead, protectionists were divided along industrial lines, each promoting its own distinct objectives....The logic of selective protectionism did not encourage industries to cooperate with each other, since the chances for congressional support increased if protectionist bills were narrowly constructed. In addition, protectionist industries did not cooperate with organized labor.[490]

The failure of this protectionist effort carries important lessons for tactical thinking about free trade today. Sen. Hollings tried again under President Carter, but Carter preferred the Cold War priority of free trade. Ronald Reagan vetoed two protectionist trade bills, in 1985 and 1988. George H.W. Bush vetoed one, in 1990.

Ronald Reagan viewed free trade as basically a good thing, but he was not a fanatic, so he was willing to deviate from it occasionally for the sake of threatened industries and to protect the technology base needed to win the Cold War. He enacted the "voluntary" automobile agreement with Japan that Carter had negotiated and imposed a tariff on motorcycles to save American icon Harley Davidson.[491] He protected steel, lumber, computer memory chips, and sundry other products.[492] Unfortunately, his trade pragmatism, while preferable to the extremism of Bill Clinton and the two Bushes, was not guided by any thoroughgoing critique of the underlying economics of free trade—beyond the idea that it sometimes didn't work in America's favor. As a result, Reagan did not go beyond relatively narrow tactical interventions.

America's last major attempt to create a full-blown industrial policy took place from 1983 to 1985 under Reagan's Commerce Secretary Malcolm Baldrige, who proposed turning the Commerce Department into a Department of Trade and Industry analogous to Japan's famed Ministry of International Trade and Industry (MITI). The proposal was killed by the ideological qualms of free-marketeers and by the efforts of the Office of the United States Trade Representative to defend its turf.[493]

JAPAN'S PROTECTIONIST HISTORY

In the 1980s, Japanese industrial policy was the object of intense American interest, which has since waned due to the deliberately cultivated mis-

apprehension that Japan is in economic decline.[494] There was a flurry of books on the subject and for a while it seemed that America might acquire a serious industrial policy of its own (which never happened). But Japan remains much more relevant to America's situation than China—which everyone is now obsessing about—simply because Japan has wages comparable to the U.S., while China competes largely on the basis of a low-wage policy that is impossible for a developed nation to emulate. And China is following Japan's old playbook anyway, so it is well worth examining Japan's trade history.

The Japanese themselves certainly believe their economic success has been due to protectionism. No one in Japan of any standing in business, government, or academe believes that Japan's success has been due to free trade. In the words of economic historian Kozo Yamamura:

> Protection from foreign competition was probably the most important incentive to domestic development that the Japanese government provided. The stronger the home market cushion...the smaller the risk and the more likely the Japanese competitor was to increase capacity boldly in anticipation of demand growth. This can give the firm a strategic as well as a cost advantage over a foreign competitor operating in a different environment who must be more cautious.[495]

The cultural roots of Japan's repudiation of free trade are extraordinarily deep—as deep, say, as the roots that make America a capitalist culture. This was, after all, a nation which literally sealed itself off from the outside world for two centuries (1635-1853). This act is regarded by most Westerners as merely odd, but it was, in fact, profoundly consistent with the enduring character of Japanese civilization.

Japan's forcible opening to the modern world in 1853, when U.S. Commodore Matthew Perry sailed his famous "black ships" into Tokyo Bay demanding trading rights, added a new element to Japan's existing authoritarian social order: the need for economic and technological sophistication sufficient to defend its existence as an independent nation. Japan promptly set about engaging the modern world on terms congenial to its own political priorities—not those of outsiders. The key slogan of the day was *fukoku kyohei*, "rich country equals strong army." Thus private economic interests have never, except perhaps for a brief liberal moment in the 1920s, been allowed to be the primary drivers of its national economy. Instead, private interests have been subordinated to the national economic interest under a system most succinctly describable as state capitalism. And protectionism is an innate part of that system.

Japan in 1945 was economically crushed, its cities smoking ruins, its empire gone. It was poorer even than some *African* nations untouched by the B-29. It seemed so far behind the United States that there was no plausible way ever to catch up. It was widely expected that Japan would end up an economic also-ran like that neighboring island chain, the Philippines. And within the economic ideology America was promoting to Japan at the time, free trade according to comparative advantage, there seemed to be no way out, as Japan had comparative advantage only in low-value industries.

History records a fascinating exchange on this topic, which encapsulates the entire postwar free trade debate. In 1955, when the U.S. and Japan were negotiating their first post-occupation trade agreement, the head of the American delegation, C. Thayer White, told the Japanese to cut their tariff on imported cars because, in his words: [496]

1. The United States industry is the largest and most efficient in the world.
2. The industry is strongly in favor of expanding the opportunities for world trade.
3. Its access to foreign markets in recent years has been limited by import controls.
4. Although the United States Government appreciates that it is necessary for some countries to impose import restrictions for balance of payments reasons...it would be in Japan's interest to import automobiles from the United States and export items in which Japan could excel.

Upon Ricardian principles, White was, of course, 100 percent correct. But the Japanese trade negotiator, Kenichi Otabe, replied that:

1. If the theory of international trade were pursued to its ultimate conclusion, the United States would specialize in the production of automobiles and Japan in the production of tuna.

2. Such a division of labor does not take place...because each government encourages and protects those industries which it believes important for reasons of national policy.

Needless to say, Japan did not choose to become a nation of fishing villages! Instead, its rulers drew the same conclusion that Alexander Hamilton had drawn 150 years earlier and Henry VII 300 years before that, opting for protectionism and industrial policy. They closed Japan's markets to foreigners in industries they wished to enter, only welcoming foreign goods insofar as they helped build up Japan's own industries. They applied administrative guidance to key industries and rigged Japan's banking system and stock market to provide cheap capital to industry.[497] Tokyo instead *protected* its fledgling automobile industry in the 1950s, limiting imports to $500,000 per year. (In the 1960s, prohibitive tariffs replaced this quota.) Japan only allowed foreign investment insofar as this transferred technology to its own manufacturers. Today, it produces over two-and-a-half times as many cars as the U.S., mostly for export.[498]

As Japan has historically been the economic leader for the whole of Confucian Asia[499] (Japan, Korea, China, Taiwan, Vietnam, Hong Kong, and Singapore), its protectionist policies have been shared with nearby nations to a huge extent. The ultimate basis of these policies is an attitude towards economics that sees the economy not as an end in itself, but as an instrument of national power. (See the quote on page 124 for a reminder of how this attitude used to be the norm even in the Western world.) As Harvard Asia specialists Roy Hofheinz and Kent Calder have written, "For more than a century, nationalist sentiments...have been a basic driving force underlying East Asian economic growth."[500] Even today, Chinese industry is 30 percent owned by the state.[501] Over a dozen strategic industries have been slated to remain under outright government ownership and control, including information technology, telecommunications, shipping, civil aviation and steel.[502] Laissez faire this is not. Socialis

In relation to its neighbors, Japan has employed something called the "flying geese" strategy, christened thus by the Japanese economist Akamatsu Kaname in the 1930s.[503] Japan breaks into an industry, wipes out existing Western competitors, then successively hands the industry down to less sophisticated neighboring economies such as Korea, Taiwan, Thailand, Malaysia, and Vietnam as they mature. This pattern has held for goods from garments to televisions for five decades. Japan's withdrawal from labor-intensive goods in the 1970s opened up space for Taiwan, South Korea, Singapore, and Hong Kong, and *their* ongoing withdrawal from these goods is opening up space for China. Among other things, this nicely illustrates how rational protectionism is a dynamic, not a static, strategy, and does not consist in defending every job and every industry.

7

The Negligible Benefits of Free Trade

HAVING LOOKED at the profound theoretical and historical reasons to doubt that free trade is the best policy, let's try some quantification of what benefits America and other nations are *really* likely to get from the current agenda to relentlessly expand it. Because the surprising news here is that even the calculations of free traders themselves indicate that the benefits of expanding free trade (if they even are net benefits, which is precisely what is in dispute) are very small. Indeed, this is what Paul Krugman, a self-professed free trader despite his trenchant criticisms, has referred to as the "dirty little secret" of free trade.[504] So even if we assume that the entire dubious edifice of free trade economics is true, there's just not that much on the table for America—or anyone else, for that matter.

That the benefits of free trade are relatively modest should be intuitively comprehensible to anyone who thinks back to the economy America had as recently as 1970.[505] Then, imports were just over five percent of GDP, rather than the 17 percent they are now.[506] Yet we somehow didn't seem to *need* very many imports to have the world's highest standard of living.[507] Imports were mainly a matter of oil, natural products that don't grow here like bananas, luxury goods like Swiss watches, and a few odds and ends like Volkswagens. This rather suggests that the benefits of free trade are at best a layer of icing on our economic cake, not a fundamental basis (let alone *the* fundamental basis, a ridiculous claim that gets made all the time) of our standard of living.