LAFFER ASSOCIATES
Supply-Side Investment Research
April 11, 2025

10-yr T-Note: 4.55%	DJIA: 39,456.24	NASDAQ: 16,388.17	S&P 500: 5,260.37	S&P 500 Undervalued: 52.8%

THE TRUTH ABOUT TARIFFS AND TRADE [Updated 04/14/2025]

By Arthur B. Laffer Ph.D.

Let me lead off with one of my favorite country songs ever by Roy Clark, "Thank God and Greyhound." This is the Trump version of America's trade relationship with the rest of the world:

<u>Verse One</u>
I've made a small fortune and you squandered it all
You shamed me till I feel about one inch tall
But I thought I loved you and I hoped you would change
So I gritted my teeth and didn't complain

<u>Verse Two</u>
Now you come to me with a simple goodbye
You tell me you're leaving but you won't tell me why
Now we're here at the station and you're getting on
And all I can think of is thank God and Greyhound you're gone!

<u>Verse Three</u>
Thank God and Greyhound you're gone
I didn't know how much longer I could go on
Watching you take the respect out of me
Watching you make a total wreck of me
That big diesel motor is a-playin' my song
Thank God and Greyhound you're gone!

<u>Verse Four</u>
Oh, thank God and Greyhound you're gone
That load on my mind got lighter when you got on
That shiny old bus is a beautiful sight
With the black smoke a-rollin' up around the tail lights
It may sound kinda cruel but I've been silent too long
Thank God and Greyhound you're gone!

The reality of incentives is straightforward. If you want more done of something, subsidize it. If you want people to stop doing something, tax it.

Tariffs on imports are a tax and will stop people from importing goods from foreigners. But there is a lot more to the story.

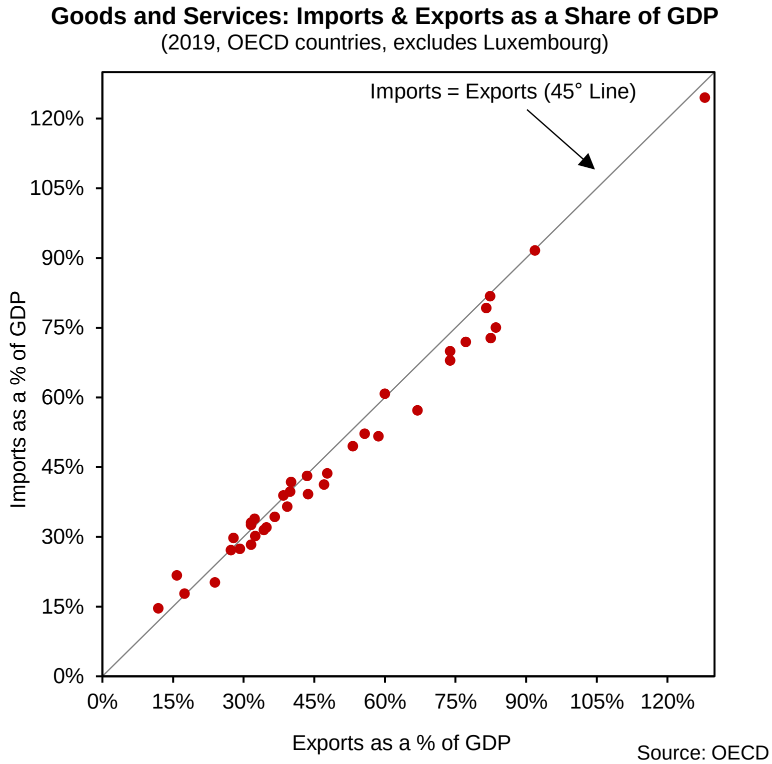
- From 1747 through 1854, the U.S. had 95 years of trade deficits and only 13 years of trade surpluses including 1775 and 1776 (the Revolution), 1811 and 1813 (also a war), 1842, 1843, and 1844 (the biggest U.S. default to foreign investors ever). America was built on trade deficits. The U.S. trade deficit funded the flow of capital into the United States and, when combined with U.S. natural resources and labor, created the most powerful economic force on earth.

- The reason people work and invest is primarily to earn income to buy goods and services produced by others. In the same vein, people in one country export products and services to earn the wherewithal to buy imports from other countries. If you tariff imports, you reduce the demand for imports which, in turn, reduces the need for the proceeds from the sale of exports and thus reduces exports. Tariffs, therefore, reduce both imports and exports, and in static terms, create jobs in inefficient domestic industries to replace the loss of efficiently made foreign imports and then lose jobs in efficient domestic industries that formerly were exported.

- Not only are tariffs a tax, but they are far worse than income taxes because they are a gross receipts tax. And here we have to be careful to distinguish among various types of items on which the government imposes taxes. First, we have income or value added taxes which correspond to taxes on the returns to factors of production such as capital and labor. Second, we have turnover or gross receipts taxes which correspond to the volume of total revenues a business has irrespective of that business's purchases or pass-through expenses. In general, gross receipts can be thought of as about four times larger than incomes.

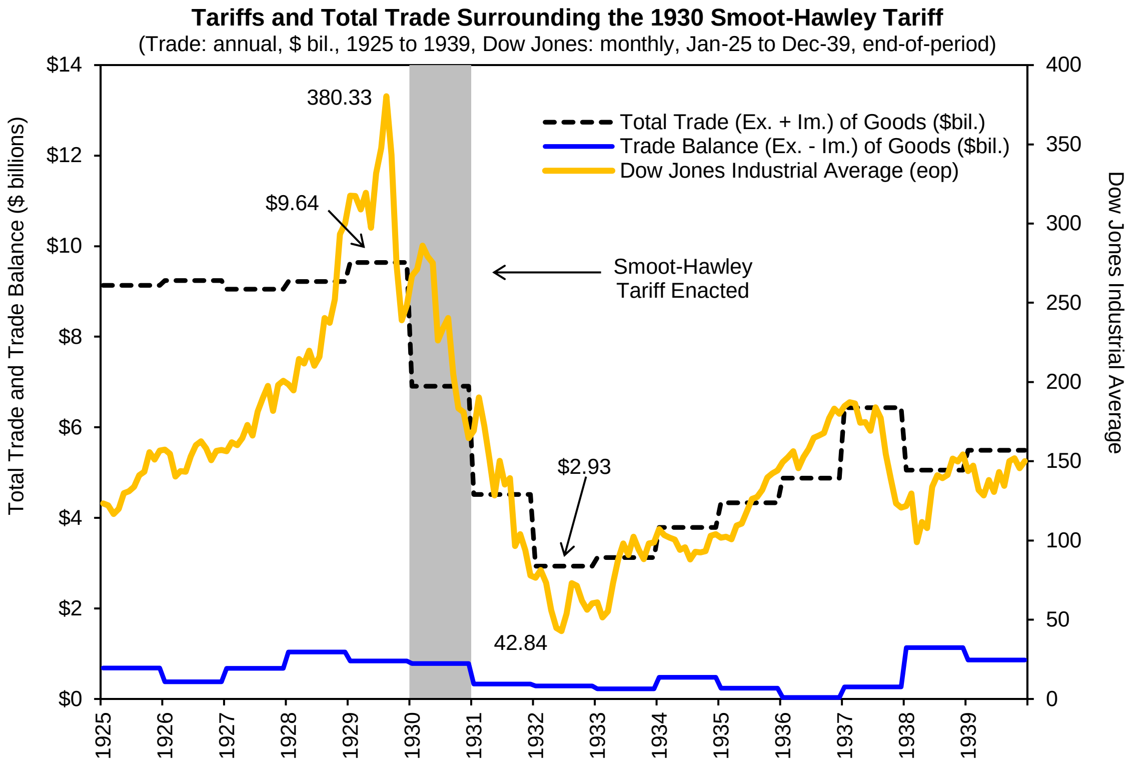
Finally, we have wealth taxes, which year after year tax the same item irrespective of the volume of business that item generates or its income. Wealth in general can be thought of as six or seven times larger than income and two or three times larger than gross receipts. In my experience, wealth taxes, percent for percent, are about three times more damaging than are turn-over or gross receipts taxes which in turn are percent for percent four times more damaging than taxes on incomes. And goodness knows income taxes can do a helluva lot of damage.

- Tariffs do not raise overall prices simply because the increase in the domestic prices of imports (products more efficiently produced abroad) are offset by the fall in domestic prices of formerly exported products (more efficiently produced domestically). In the chart below the precise correspondence between a country's imports and its exports is about as tight as could be imagined.



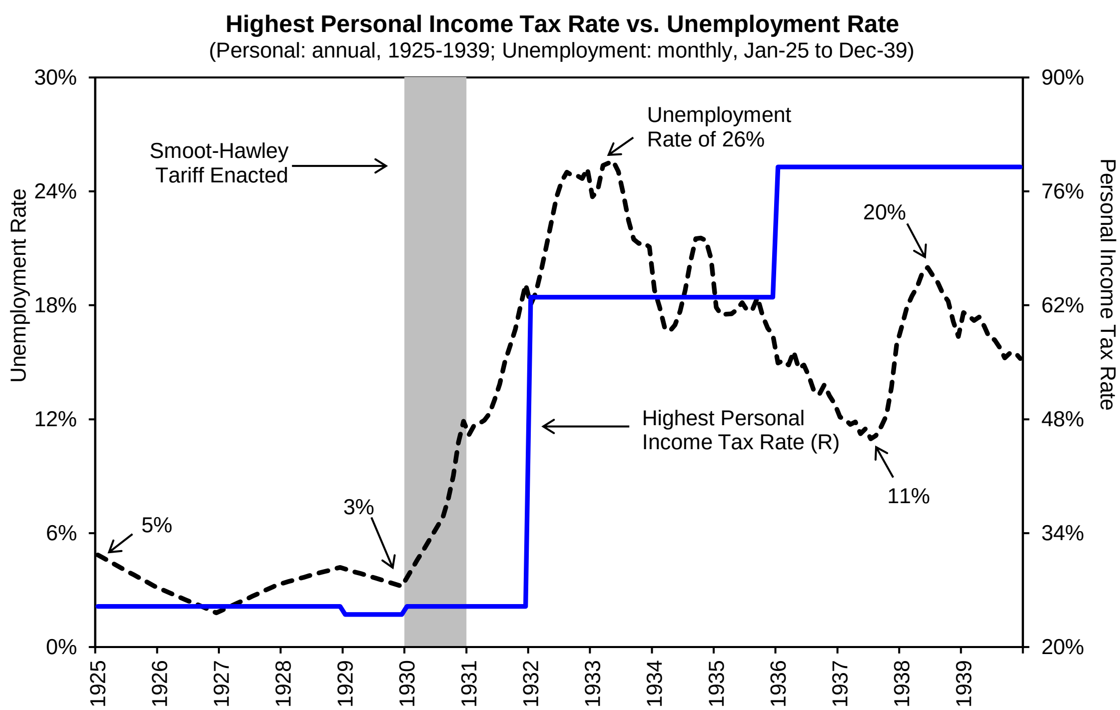
Moving on from words to facts, after the Smoot-Hawley tariff, the U.S. price level actually fell and fell by a lot. Under the Kennedy Round tariff reductions, there appears to have been little effect on inflation. Nor did the Reagan/Clinton NAFTA trade liberalization appear to have had any noticeable effect on inflation. Nixon's 10% import surcharge was in response to higher inflation numbers and again inflation did not appear to increase. We could look all across the world but suffice it to write—inflation most likely isn't the issue either way.

- Tariffs also do not *per se* change a country's net exports or what is called its trade balance, as is also evident from the exports and imports chart. If imports and exports move in lockstep, their difference (i.e. the trade balance) won't change. Looking back in time at the period surrounding the Smoot-Hawley tariff, there was an enormous drop in the volume of trade, the stock market, and total employment, but the objective of the tariffs—the trade balance—barely wiggled. The chart below shows total trade, the stock market and the trade balance in and around the Smoot-Hawley Tariff. The stock market fell from top to bottom by 88.7 percent. Total trade fell by 69.6 percent. But the trade balance? Nada.



Source: Bureau of Economic Analysis, Historical Statistics of the U.S., U.S. International Trade Commission

- Tariffs do cost jobs and do reduce productivity as a result of a loss of the comparative advantage gains from trade. Also, the collapse in total commerce as a result of tariffs leads to domestic tax revenue shortfalls and prompts domestic governments to raise tax rates everywhere. This perverse government response is a sure-fire way of causing an economic bust. The next chart shows the time sequence of a.) the adoption of the Smoot-Hawley Tariff, b.) subsequent increases in unemployment, c.) government response of raising tax rates, and d.) further increases in unemployment. It's all a vicious cycle spiraling the economy further and further into the Great Depression. This truly is a race to the bottom.



Source: Bureau of Labor Statistics, Historical Statistics of the U.S., Tax Policy Center

- Tariffs also lead to further job losses because of atavistic urges of foreign governments to enter a trade war. Matching tariff increase for tariff increase is precisely the wrong thing to do yet governments everywhere at all times do just that. The end result of the trade war in addition to a stock market collapse is a magnified decline in trade for both imports and exports and very little if any change in the trade balance.

- Tariffs in addition to everything else will not raise much if any net revenues for government. As an add on, increased tariffs will reduce the overall take from taxes. This point was a central tenet of Adam Smith in his book *The Wealth of Nations*. After 1929 and the large hike in tariffs, the economy collapsed, and government tax revenues disappeared. The same occurred with the Nixon tariffs of 1972. Overall tax revenues increased and the U.S. budget went into surplus when Kennedy in the 1960s and Clinton in the 1990s lowered tariffs.

- The idea that low-priced foreign-made goods constitute dumping and cost jobs is generally not correct. It is also incorrect to measure damage to the U.S. economy by specific industry job losses. Even during the greatest periods of boom, there are a few industries that suffer. And, conversely, during periods of bust there are a few industries that do well. People work and invest to buy goods and the higher the quality of those goods and the lower their price, the better off workers and investors are. Protecting this industry or that industry from foreign competition by imposing tariffs comes at the expense of everyone. As individual consumers, we all like bargains—high quality products sold to us at low prices. It should be no different for countries. Would we like countries to over-charge us for their products, or worse yet, would we hate it if foreigners sold us high quality products at low prices? Imagine if Japan, out of gratitude, gave us all of their cars as a gift free of charge, should we declare war? I think not. When the U.S. buys products globally at retail-plus we call it fair trade. When we negotiate prices and buy products below wholesale, it’s called foreign dumping. Go figure! Remember, consumers matter too.

- When it comes to government policies, foreigners and Americans alike like low taxes, spending restraint, sound money, minimal regulations, and free trade. Bringing manufacturing and jobs back to America requires the same set of policies that expanding manufacturing and jobs in America does. For Americans, the choices are simple—save more, invest more, and watch your wealth grow.

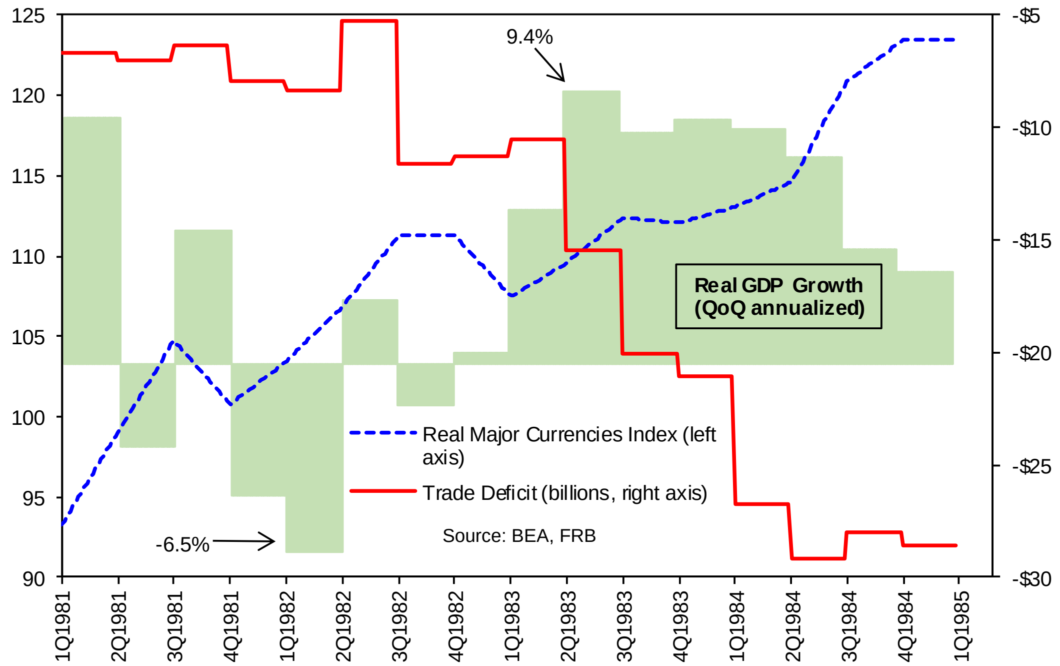
- Foreigners, on the other hand, can on balance only invest in the U.S. if they sell more goods to Americans (an increase in U.S. imports) and buy fewer goods from Americans (a reduction in U.S. exports). Only in this way can foreigners generate the dollar cash flow to buy U.S. located assets. In other words, the U.S. trade deficit is the U.S. capital surplus. If you want manufacturing to relocate to the U.S., the U.S. must run a trade deficit which is a U.S. capital surplus. Think about it.

- A U.S. trade deficit with China can only occur when the Chinese economy invests more in the U.S. than the U.S. economy invests in China. A U.S. trade deficit with China means we win! We get more investments. China’s trade surplus with the U.S. (the U.S. trade deficit with China) provided 1.5 million net new jobs in the U.S. in 2017.

Which would you prefer: investors lined up on our country’s borders trying to get into America, or lined up on our borders trying to leave America? Ouch! A U.S. trade deficit is a measure of just how much foreigners are investing in the U.S.

- In the chart of the Reagan years, the 1981 ERTA tax bill took effect on January 1st, 1983. For the full two-year period of 1983 and 1984, U.S. real GDP grew by 14% or 6.5% per annum. Also starting in the first half of 1983 there was an enormous increase in the inflow of foreign capital into the U.S. as shown by the dramatic increase in the U.S. trade deficit and a sharp rise in the value of the U.S. dollar in the foreign exchanges.

The Dollar, The Reagan Years, GDP Growth, and the U.S. Trade Deficit
(quarterly, 1Q-81 to 4Q-84)



- The second part of the consequences of good economic policies in America—in addition to our trade deficit/capital surplus—is a strong dollar. Increased demand for U.S. located assets, like the increase in demand for any product, will have a quantity effect (trade deficit) and a price effect (a strong dollar). See graph above.

If a businessman in Mexico as a consequence of President Trump's pro-growth policies decides to move his business to the U.S., how would he do it and what would it mean? Let's say he loads up all of his capital equipment on a truck in Mexico and drives that truck over the U.S./Mexico border to its new home in the U.S. By moving his manufacturing facilities, machines and all, the U.S. now has a new production facility (a capital surplus) and Mexico has lost a production facility (a Mexican capital deficit). Said differently, taking these machines over the U.S./Mexico border is a Mexican export and a Mexican trade surplus and at the same time it's a U.S. import and a U.S. trade deficit. U.S. trade deficits are one and the same as U.S. capital surpluses. The U.S. now has the jobs and Mexico doesn't.

- The idea that trade deficits constitute an export of U.S. net worth is not correct. Our periods of biggest trade deficits have occurred when U.S. net wealth rose the most. Yes, foreigners owned more U.S. assets, but Americans also owned more U.S. net assets. In fact, both foreign-owned and U.S. owned assets in the U.S. rose for the same reasons. The total wealth rose in response to great economic policies. Trade deficit periods are win-win periods for both Americans and foreigners.

- U.S. wealth went up an amazing $40 trillion from 2008 to 2018—from $60 trillion to $100 trillion—and the cumulative trade deficit from all countries (i.e. the increase in assets owned by foreigners) went up only $2.8 trillion. We aren't selling out to foreigners.

Without wanting to carry the arguments to the absurd extreme, the idea as one tariff advocate said, "with tariffs, those empty factories in Detroit can rapidly be filled with American car production" is silly. Detroit is a basket case not because of China, Germany, Japan, and Italy. It's a basket case because of Michigan and specifically Detroit: taxes, regulations, minimum wages, death taxes, and forced union laws. In Detroit, there are areas where property taxes exceed 15%. Yikes! Whoever would want to move anything to Detroit? No one. Tennessee, Texas, and Florida have no problem with manufacturing job losses. In fact, we almost have too many manufacturing jobs moving into our states. But then again, our states are pro-growth states without state income taxes. The problem of manufacturing in the U.S. is U.S. federal, state, and local policies. If the Rust Belt were to adopt the fiscal structures of Utah, Nevada, Florida, Texas, and Tennessee, the problem would be solved. We've met the enemy and, to quote Pogo, "they is us."

No Personal Income Tax States* vs. Indistrial States**
(2020-2021 AGI Migration, in thousands of dollars

	0 PIT States	Industrial States
Total AGI Inflow	$ 121,793,619	$ 85,038,041
Total AGI Outflow	60,527,142	164,092,138
Net AGI Inflow	61,266,477	79,054,097
Average AGI In-Migrant	$ 113	$ 84
Average AGI Out-Migrant	74	115

*No PIT States include: AK, FL, NV, NH, SD, TN, TX, Source: Census

**Industrial States include: CA, IL, MA, MI, MN, NJ, NY, OH, PA

Summary

- When viewing tariffs in the grand scheme of things, they represent government intervention in the marketplace. Tariffs are the antithesis of free market economics. Many of the arguments used to further the adoption of tariffs are perceptions of market failures. The one over-riding theme is that whatever the perceived problem may be, government is the solution. And even when perceptions of the problems are demonstrably wrong, tariff supporters still want a government solution. In total frustration one such tariff advocate in response to Elon Musk's paper advocating free trade referred to Elon Musk as "a car salesman who doesn't understand and only wants to protect his own interests." Has he never heard of Musk's rewriting of the book of entrepreneurship, namely Musk's business accomplishments? To name a few: the Zip2 disruption of the Yellow Pages; Paypal; Tesla, at once an unheard-of car company startup and the electric-vehicle pioneer; SpaceX, getting NASA out of its decades-long funk (even to the degree of rescuing its pair of nine-month-stranded-in-space astronauts); Starlink, globally busting the "cable-guy" monopoly in internet service; Twitter/X, which has put legacy media to pasture; the Boring Company; Hyperloops; the Neuralinks that give new functionality to victims of paralysis; XAI; the now totally reasonable prospect of planting civilization on Mars. Howard Hughes, Jacob Astor, John D. Rockefeller, George Westinghouse, and the whole honor roll of top entrepreneurs of the past salute you from the beyond, Mr. Musk.

Gross Domestic Product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. **Nominal GDP** is a measure of economic output that uses current prices and does not adjust for inflation. **Real GDP** is an economic metric that is used to describe the economic output of a country within a specific year. It reflects the value of all goods and services produced while factoring inflation into its calculation.

"AGI" as used in the article refers to adjusted gross income, which is an individual's total gross income minus specific deductions. It is the number that the Internal Revenue Service (IRS) uses to determine your income taxes owed for the year.