TARIFFS: EXPECTATIONS VERSUS REALITY...

COMMENTARY

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Stratos Investment Management
3750 Park East Drive
Beachwood, Ohio 44122

Tariffs have been quite the buzzword since President Trump talked them up when he began his first (successful) campaign for the presidency and have been a focus of the Trump administration as he begins his second term. What gets lost in the noise are some of the realities of tariffs and their use historically: both as a means of raising revenues for the federal government and as a means of protecting domestic producers. Over the next several paragraphs we hope to shed some light on the matter, as well as offer our thoughts on what we view as the most likely outcome.

Tariffs in History

As a fledgling country without much means of producing revenue, the use of tariffs by the newly minted United States of America was a logical way to bring in much needed resources to the Treasury. (The first tariff law was enacted in 1789.) While the United States was able to raise revenue by selling its publicly owned land, most revenues came from tariffs. The chart below, which shows tariffs as a percentage of total government revenue, supports this.

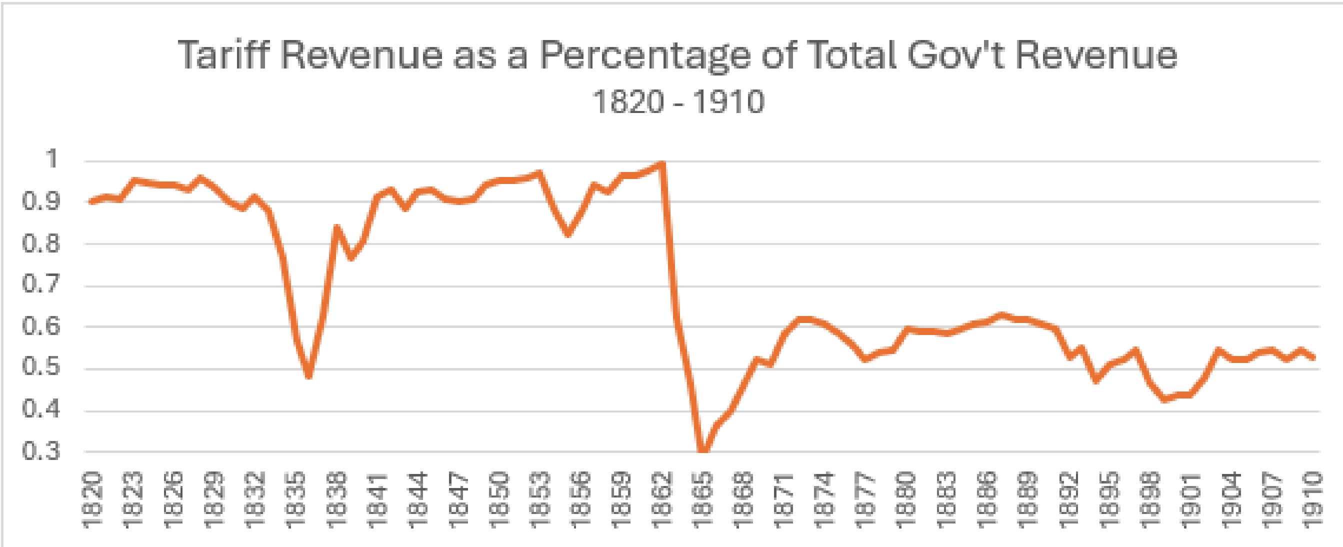

Figure 1 - Source: CRS Report for Congress: US Federal Government Revenues 1790 to Present; govinfo.gov

There were, as you will note, three periods where tariff revenue fell below fifty percent of total federal government revenues. These are the periods from 1835-1836 (significant sales of government lands), 1864-1868 (excise taxes introduced and became a significant source of government revenues), 1898-1902 (tariff rates were cut from approximately 50% to 40%) and then permanently below fifty percent of revenues in 1911.

Tariff rates have varied significantly since the founding of the United States, depending on whether the federal government wanted to raise revenues (as was the case early in its existence) or protect industries and goods from foreign competition (largely the case since the 1820s). While the Smoot Hawley tariffs[1] are often blamed as an example of what bad tariff policy can do to the economy, it was far from a peak in tariff rates. That ignominious distinction belongs to the Tariff of Abominations in 1828[2] (see figure 2). That said, the Smoot-Hawley tariffs did kick off a global trade war.

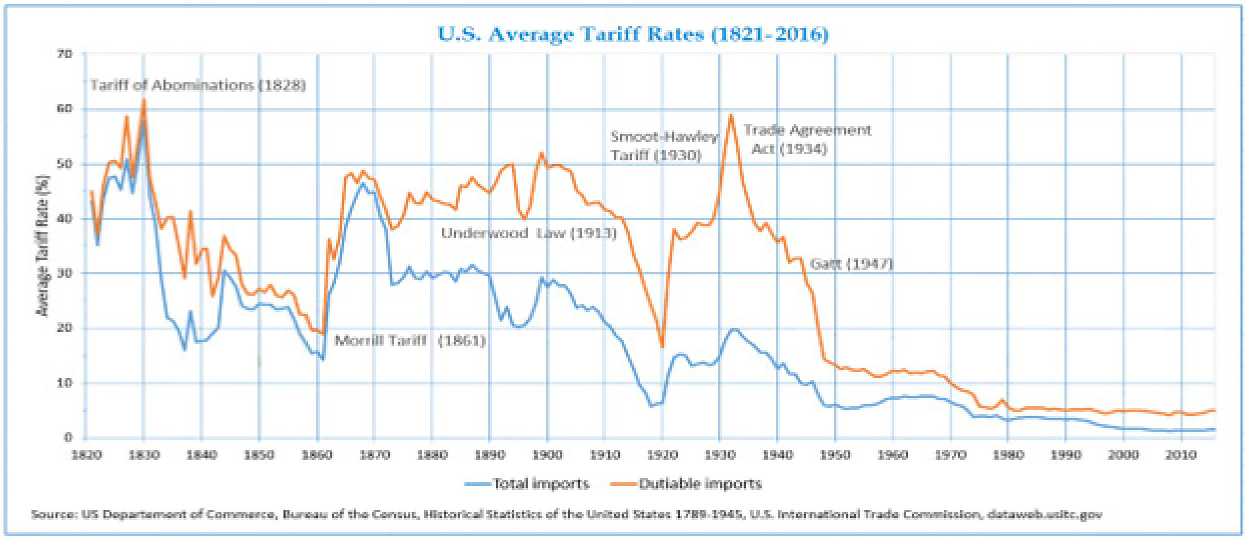

Figure 2 - Wikipedia: History of Tariffs in the United States

With the introduction of the Revenue Act of 1913 (also known as the Underwood Tariff Act of 1913), which permanently established a federal income tax, revenue from tariffs became a lower component of federal government revenue, declining to less than 2% of revenues in 1959. (See Figure 3 below.)

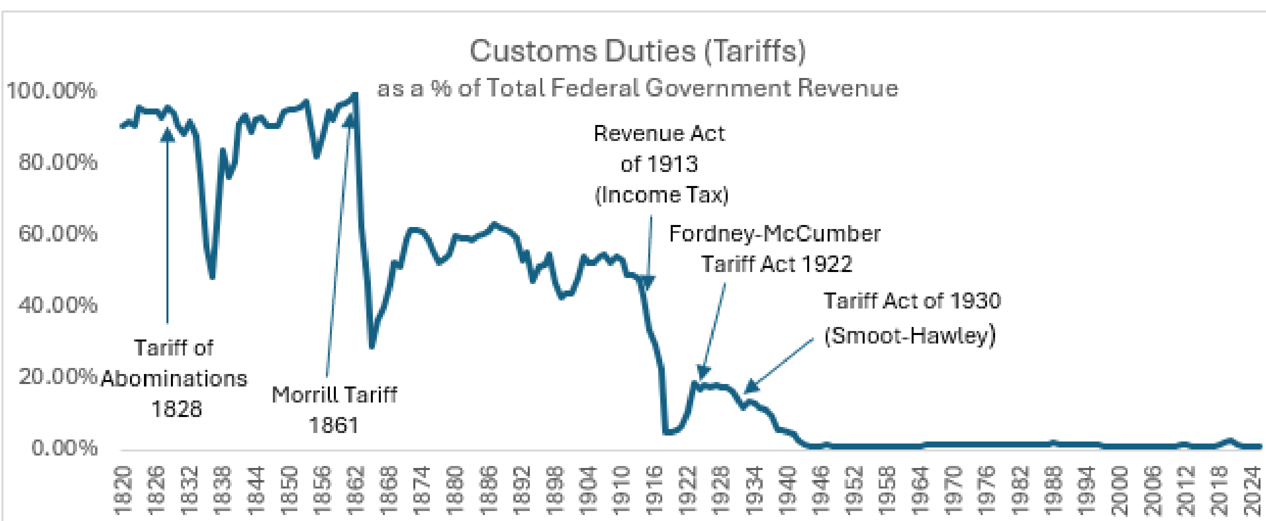

Figure 3 - CRS Report for Congress: US Federal Government Revenues 1790 to Present; govinfo.gov

Rationale for Tariffs

In our view, there are only two reasons for the use of tariffs: 1) to raise revenue or 2) to be used as a means of protecting domestic production of goods and services. While President Trump has talked about taking in "trillions and trillions of dollars" the reality is that, assuming no drop off in imports, tariffs would need to rise by more than twenty times to get to $1 trillion. (The estimate for 2024 tariff revenue was just over $45 billion.[3]) The reality is, that increasing tariff rates to a level that will raise even $1 trillion isn't practical. While the current Trump proposal would take average tariff rates from 2.4% to 17.7%, in order to (theoretically) raise at least $1 trillion, average rates would need to rise to at least 40%. This is a level not seen since the Civil War (assuming the average rate for all imports is the focus – see figure 4 below).

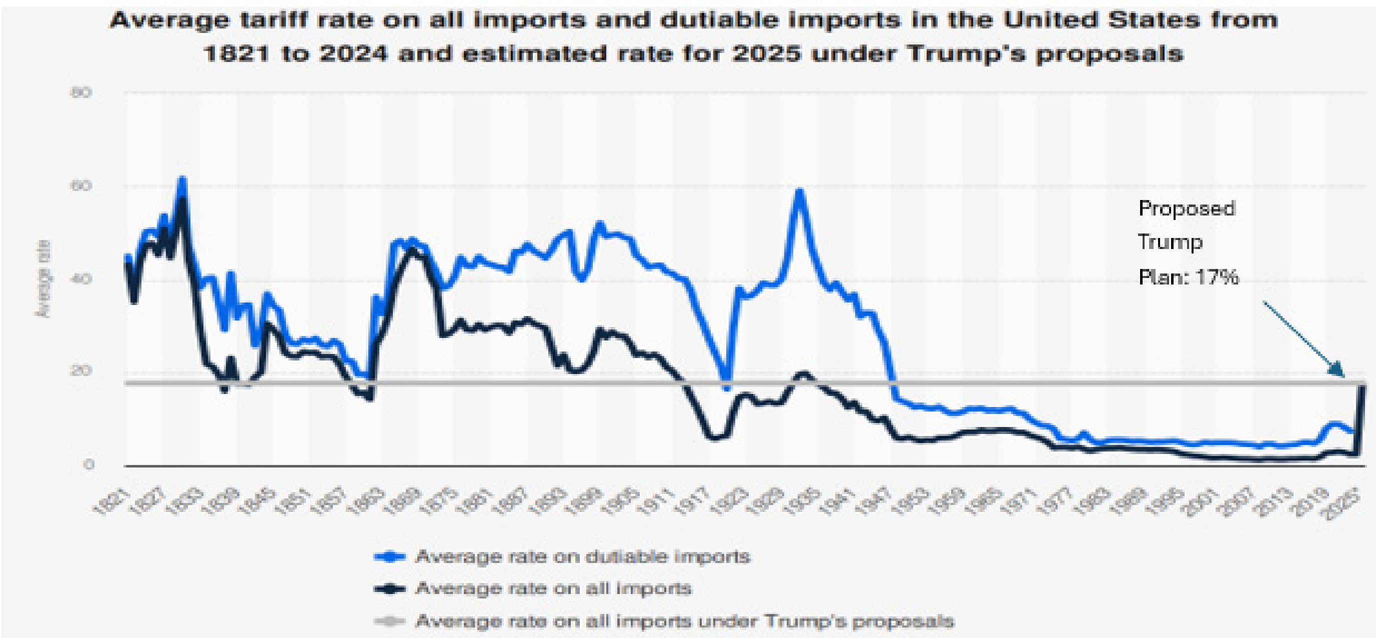

Figure 4 - Source: Statistica; Tax Foundation

If we look at gross output of the US economy, as described by the GDP data provided by the US Bureau of Economic Analysis, we note that manufacturing, mining and construction ceased being the majority of GDP in the late 1960s (see figure 5).

Much like the United States shifted from being an agrarian economy to a manufacturing economy in the mid-1800s (the industrial revolution), we believe that the US economy has been undergoing another shift - one focused more on knowledge (in GDP terms "services"). The benefit of this shift is that efficiencies are found in the "old economy" (agriculture in the

1800s and manufacturing beginning in the 1970s) that move jobs out of "old economy" and into the "new economy". Because the "old economy" jobs have been eliminated through efficiency (think bailers baling hay versus a person raking and binding it by hand), they likely aren't coming back – at least not nearly as many.

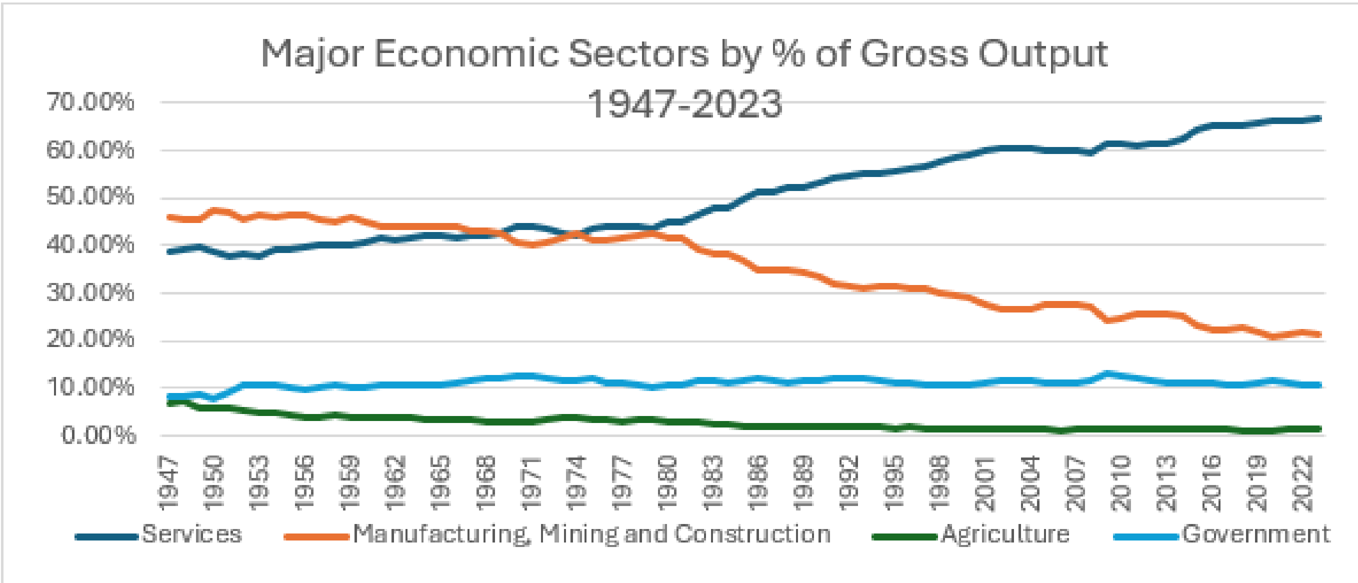

Figure 5 - Source: Bureau of Economic Analysis

A more recent example is the transition from ICE (internal combustion engine) vehicles to EVs. There are fewer parts needed in an EV relative to an ICE vehicle, so there are fewer people needed to build and EV (and its component parts) than a similar ICE vehicle[4]. Those jobs eliminated in the transition will likely not return.

What Happened Last Time?

Remember, this is Trump 2.0 (second Trump administration). During the first Trump administration (2017-2021), he also increased tariffs - from approximately 2% to approximately 14% (see figure 6 below). This, roughly seven times multiple increase in tariff rate, resulted in a nearly $30 billion increase in tariff revenue (or more than 70% from 2018 – 2019). (Tariff revenue had increased by 19% in 2018 from $34.6 billion to $41.3 billion.) Tariff revenue peaked at over $92 billion in 2020 before declining under the Biden administration, albeit settling in at revenue levels still above the first year of Trump tariffs.

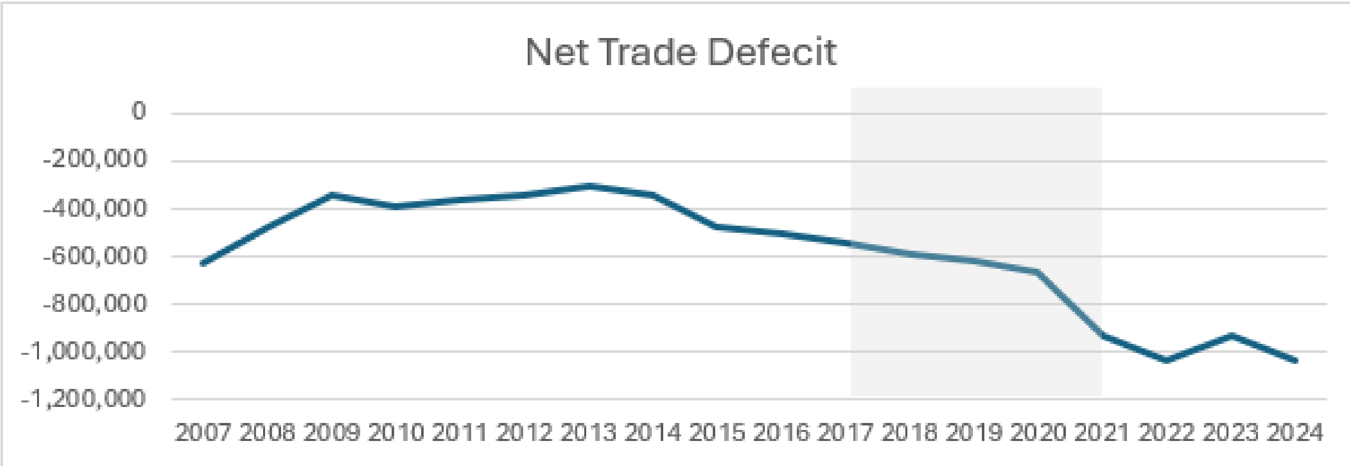

Figure 6 - Source: Bureau of Economic Analysis

Did the Trump 1.0 (first Trump administration) tariffs raise revenue or reduce the trade deficit? It depends. At its peak (2020), revenue from tariffs represented just under 2.5% of federal government revenues (up from just over one percent of revenues in 2016). The trade deficit worsened under Trump 1.0 tariffs, declining from a deficit of just over $500 billion at the end of the Obama administration, to more than $660 billion at the end of Trump 1.0 (see Figure 6 above). However, we think that the post-COVID snap-back in spending may have been a reason for the acceleration in imports towards the end of his first administration (see figure 7 below) as there did seem to be a clear (albeit small) closing of the trade deficit as we neared 2020.

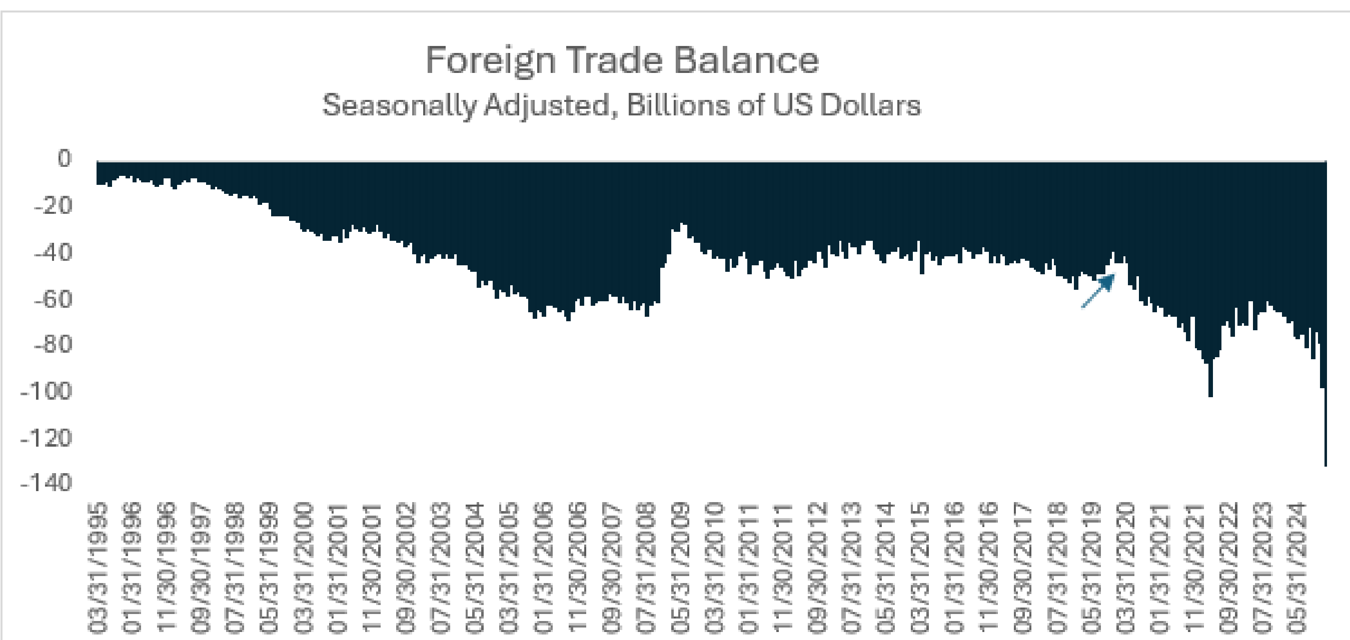

Figure 7 - Source: FactSet

You will also notice the rather extreme jump in net imports (negative balance of trade) as we began the current year. We believe this should be attributed to purchasers loading up on inventory in expectation that the Trump administration will be more aggressive with tariff policy this time around – which it appears they are.

Does Protectionism Work?

If revenue raised, as a percentage of total federal government revenue, isn't likely to be that significant then protectionism would seem to be the operative word for the current round of tariffs. As such, the big question should be, "does protectionism work?" In our view, it depends. It depends on whether or not a country is able to 1) produce adequate supplies of all its economy's needs within its own borders and 2) whether it is able to increase exports enough (or reduce imports enough) to drive the trade deficit to zero and 3) whether the protectionist tariffs set off a round of international retaliation either through increased retaliatory duties, boycotts of US goods and services or a shift to some other means of exchange. (Back in the Smoot-Hawley era, much of the globe's currencies were pegged to gold. Today, approximately half of global trade is based on dollars.)

Can we produce adequate supplies of goods within the United States to meet internal demand? The quick answer is, "no." Two specific examples are televisions (the last American television manufacturer, Zenith Electronics, declared Chapter 11 bankruptcy with its assets being sold to LG[3] and the last American color television manufacturer Five Rivers Innovations ceased production in 2004[5]) and cell phones (the last date for domestic production of cellular phones was 2007[6]).

Andrew Jackson or Herbert Hoover?

While President Trump likes to fashion himself a modern-day Andrew Jackson (the 7th President of the United States) who had also been a champion of high protective tariffs, Herbert Hoover (the 31st President of the United States) is the risk.

Jackson's war record seemed to indicate that he had the decisiveness and independence to bring reform to Washington. He was also promoted as an outsider who stood for the people, blaming banks for the country's depression (the Panic of 1819). When he agreed to run for the Presidency (he had been put forth as a candidate to keep Tennessee's electoral votes from going to William Crawford – an early favorite), his unexpected support outside of Tennessee made him a serious candidate.

Interestingly, even though Jackson is often viewed as a friend of the tariff, it was John Quincy Adams' signing of the "Tariff of Abominations", which was a tax on European imports, that set the (high) bar on tariffs and cost him southern support and the 1828 election.

While Herbert Hoover had worked for the Democratic Woodrow Wilson administration, he had not been closely affiliated with either party. His wartime push for higher taxes (WWI) and his advocacy for the minimum wage, the 48-hour workweek, etc., gave him appeal to progressives within both Democratic and Republican parties. During early 1920, he changed strategies (having initially decided to avoid coming out in favor of either party), and declared himself a Republican – largely because he didn't believe the Democrats had a chance in the election of 1920.

With the stock market crash of 1929, protectionist fervor gained strength and what became known as the Smoot-Hawley tariffs were introduced and passed with the intent on protecting American agriculture from low prices brought on by improving European agriculture production as they recovered from WWI. This improvement in agricultural production led to overproduction, causing prices to fall. The tariff legislation was signed in June 1930.

The much higher tariffs coupled with retaliatory tariffs from overseas caused US exports to, and imports from Europe fall by two-thirds from 1929-1932 and overall global trade followed a similar pattern. Additionally, monetary policy missteps by the Federal Reserve created liquidity issues that resulted in the Great Depression.

Are we saying that the past is prologue? No. We do, however, believe that it is helpful to understand the steps that led to policy mishaps so that we know what to look for from an economic and market standpoint.

Ultimately, the President doesn't have authority, under the Constitution, to enact or set tariff rates. That is reserved for Congress under Article 1, Section 8. However, under the Reciprocal Trade Act of 1934 (signed by President Roosevelt), the President was authorized to negotiate trade deals with the approval of Congress. Later acts further expanded the authority however, this power is not unchecked. Key provisions within the acts provide Presidential authority to impose tariffs, but only, ultimately, with Congressional approval.

Some of the provisions include:

- Section 232 of the Trade Expansion Act of 1962 allows the President to impose tariffs if imports threaten national security and after a thorough investigation.
- Section 301 of the Trade Act of 1974 lets the President impose retaliatory tariffs to counteract unfair foreign trade practices.
- The International Emergency Economics Powers Act (IEEPA) gives the President authority to regulate commerce during national emergencies involving foreign threats, requiring a formal declaration.

What Can We Learn?

Ultimately, we believe the numbers bandied about by the administration are most likely being used as leverage – as a means of extracting concessions. While President Trump does have the authority to impose tariffs under certain circumstances, those tariffs must (eventually) come under congressional review. Can economic damage be done (both actual and inferred) until that happens? Certainly.

President Trump seems to have learned from his first term. We believe that because of the "stall tactics" Beltway insiders used during his first administration, he believes that he was too willing to wait for things to happen as he (tried) to "play by the rules". Since beltway insiders (the Swamp in his supporters' words) will try to roadblock his agenda, we think his intent is to flood the apparatus with so much activity that they can't kill it all. Hence the flurry of activity.

Will there be some dislocation? There already has been some negative fallout. The markets have been in a (seeming) tailspin since approximately mid-February (NASDAQ recently nearing correction territory), and President Trump refusing to rule out a recession this year, commenting to Fox News that "there will be a period of transition, because what we're doing is very big."

What we have learned from more than thirty-five years in the investment business and experiencing more than a couple of periods of extreme volatility, is that we can use periods like this as an opportunity. They also serve to remind us that risk is ok – if we get paid for it. We have also learned that the market treats investments indiscriminately during times of uncertainty. We believe patient and attentive investors should be able to find very attractive investment opportunities.

1. Smoot-Hawley tariffs: This was legislation that raised import duties (tariffs) to protect American business and farmers. The Tariff takes its name from the original Act's chief sponsors, Senator Reed Smoot of Utah and Representative Reed Smoot of Oregon. "Smoot Hawley Act", Editors of Encyclopedia Britannica, Jan 13, 2025
2. Tariff of Abominations (1828) also know as the Tariff of 1828 was so called by its Southern United States detractors because of the effects it had on the Southern economy. "Tariff of Abominations", Wikipedia.org
3. Source: govinfo.gov
4. Source: "Do Electric Vehicles Have Fewer Parts? (Direct Comparison)" by Peter Jones, Motor and Wheels, October 19, 2023.
5. Source: "Zenith Electronics", Wikipedia.org
6. Source: "18 Iconic Products That America Doesn't Make Anymore", by Anika Anand, Business Insider, October 18, 2010.