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INSIGHT

Tariffs and Federal Finances: A Thumbnail History

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Tariffs and other customs charges were the largest source of federal revenues in the 18th and 19th centuries. Tariffs are taxes on imported goods. This Insight offers a brief history of U.S. tariff policy and the interaction between import taxes and public finances.

Tariffs historically served three main purposes: (1) they provided revenues to support debt service and government functions without engendering the sometimes fierce opposition to excise taxes; (2) they have been instruments of commercial and industrial policy by raising the cost of imported goods; and (3) at high levels they might provide leverage to persuade other countries to lower trade barriers.

In the first decades of the United States, collecting customs duties at a limited number of harbors was simpler than administering an internal revenue system, such as for collecting alcohol taxes. Tariffs, therefore, generated the bulk of federal revenues until the Civil War. Economic downturns and disruptions of international trade, however, made customs a volatile revenue source. Moreover, tariff policy had strong regional effects, with financial centers and manufacturing areas generally favoring higher rates and agricultural areas favoring lower rates. Setting rates was a major political issue for Congress until the mid-1930s. Lowering tariffs and other trade barriers was an integral part of responding to the Great Depression and reconstructing the international financial order in the years following World War II. During the 20th century, tariffs became a minor federal revenue source.

Alexander Hamilton and Protecting Duties

The first U.S. Treasury Secretary, Alexander Hamilton, in his 1791 *Report on Manufactures*, advocated for "protecting duties" and bounties (i.e., government subsidies) to develop local production as well as low tariffs on raw materials. In 1792, his recommendations for tariffs were largely adopted and those for bounties were rejected. Those tariff rates were moderate relative to those imposed in the 19th century. Hamilton, noting the risks of heavy reliance on customs revenues, wrote "exorbitant duties on imported articles ... tend to render other classes of the community tributary in an improper degree to the manufacturing classes to whom they give a premature monopoly of the market; they sometimes force industry out of its more natural channels into others in which it flows with less advantage."

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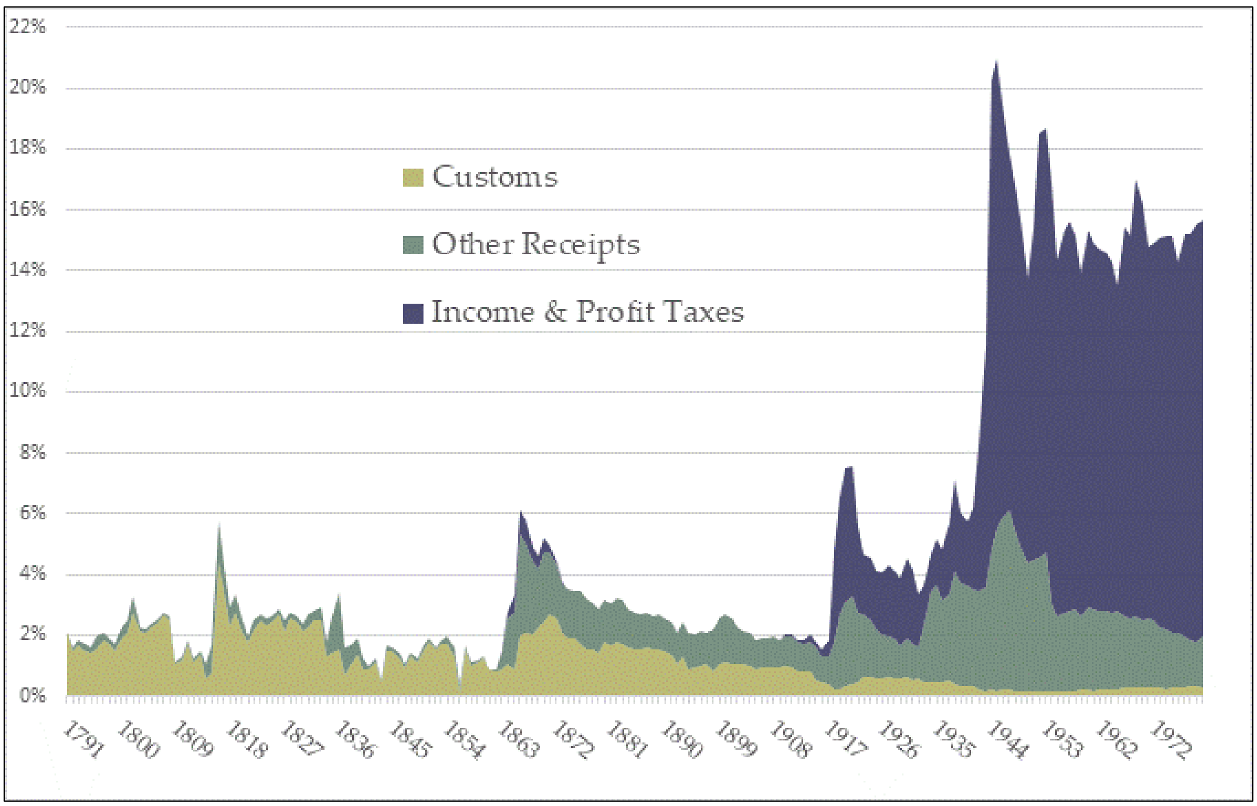
Reliance on Tariffs Contributes to Federal Default in 1814

After President Thomas Jefferson took office in 1801, Congress repealed the direct and excise taxes, leaving federal coffers dependent on tariff and customs revenue. A decade later, when turmoil in Europe reduced transatlantic trade, Treasury Secretary Albert Gallatin called for imposing internal taxes to supplement falling customs revenues and hoped loans would cover shortfalls. Shortly after the United States declared war on Great Britain in June 1812, Congress doubled customs rates and authorized Treasury to issue notes rather than collecting internal revenues. By mid-1813, the government could only borrow at unusually high interest rates. Later efforts to borrow from American banks and European markets were rebuffed. In 1814, newly appointed Treasury Secretary Alexander J. Dallas complained Treasury "was suffering from every kind of embarrassment" and that "the dividend on the funded debt has not been punctually paid; a large amount of treasury notes has already been dishonored." Under that fiscal pressure, Congress approved excise taxes, mainly on distilled spirits.

Congress repealed those excise taxes in 1817 after customs revenues rebounded. Until the Civil War, federal finances relied on customs and, to a lesser extent, land sales, as **Figure 1** indicates.

Figure 1. Federal Receipts as Percentage of GDP, FY1791-FY1980



Source: CRS calculations based on 1980 Treasury *Statistical Appendix* and Williamson.

Note: Omits payroll taxes transferred to trust funds.

The Civil War and the Reordering of Federal Finances

The outbreak of the Civil War forced fundamental changes in federal finances. In the decade preceding the war, declining tariff revenues had required heavier borrowing. After Members from seceding states left Congress, tariff increases drafted by Representative Justin Morrill were enacted in March 1861.

Treasury Secretary Salmon Chase had initially proposed meeting most war costs with loans. As Congress grasped the magnitude of the war and the insufficiency of existing revenues, it authorized broader taxes. In July 1862, Congress approved an assortment of excises and the first U.S. income tax, along with an Office of Internal Revenue. In total, customs were 9% and internal revenues were 11% of Civil War-era revenues. Loans and the issuance of greenbacks—Treasury notes that circulated as currency—financed the rest. Later in the 19th century, tariff revenues provided most of the funds to service loans and redeem greenbacks at gold standard par.

Reconstruction, Tariffs, and Pensions

Civil War debts shaped late 19th century fiscal policy. In 1872, the wartime income tax was repealed, and tariffs resumed their central fiscal role. Rapid economic growth, if at times uneven, buoyed collections of tariffs and excises and helped fund federal infrastructure investments and an expanding pension system for Union veterans and their families.

Tariff rates generally rose during Republican Administrations and fell during Democratic ones. In 1894, Democratic party majorities in Congress passed the Wilson-Gorman Tariff Act to lower tariffs and reestablished the income tax. The next year, the Supreme Court held that the income tax provisions were unconstitutional. After the 1896 elections, tariffs were raised to the highest rates yet.

16th Amendment and the Underwood-Simmons Tariff

The 16th Amendment, ratified in 1913, responded to the Supreme Court's holding that the income tax was unconstitutional and empowered Congress to levy taxes on incomes "from whatever source derived." President Woodrow Wilson pushed forward a limited income tax and reduced tariffs through the Underwood-Simmons Act. After World War I, tariffs were again raised, although income taxes became the mainstay of federal revenues. Tariffs' prominence as an instrument of industrial and agricultural policy rose—as their fiscal significance declined.

The Great Depression and Smoot-Hawley Tariffs

In 1930, Congress sought to protect farm and manufacturing interests by passing the Smoot-Hawley Tariff Act. The act raised U.S. tariffs from already high levels set in the 1920s. Some blamed those tariff increases for worsening the Great Depression, as U.S. imports and exports fell 40% in the following two years. Some economic research estimated smaller direct effects on trade and employment and assessed larger macroeconomic forces as the key cause of falling trade volumes. The profound disruption of other countries' finances, however, led to an upsurge in retaliatory tariffs. The falloff in international trade prompted Congress to change its approach. Until that time, Congress had usually retained close control over reducing tariffs. In 1934, however, Congress authorized the President to negotiate bilateral trade agreements and reduce U.S. tariff rates without further congressional action to expand markets for U.S. exports. Delegating that authority to the President laid the groundwork for broad postwar trade agreements.

Creation of the Postwar International Trade System

After World War II, the United States led efforts to build a new international financial order to help rebuild countries shattered by war. Key leaders argued that making economies interdependent in the postwar era would help avoid future world wars. In 1947, the General Agreement on Tariffs and Trade (GATT) began an era of lower tariffs and trade barriers, leading to greatly expanded international trade. In 1995, the World Trade Organization (WTO), building on the GATT framework, encompassed a broader array of goods and services and stood up a more robust trade dispute resolution process.

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