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The Economics of Tariffs:

Can Restricting International Trade Be Good For The Economy?

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United States trade policy can have substantial impacts close to home.

In 2015, over 40% of the more than $30 billion in North Carolina exports went to three countries — Canada, Mexico, and China — who have threatened to "retaliate" if their producers are negatively affected by changes in U.S. trade policy.

This issue of the NC State Economist reviews the economic impacts of tariffs and other taxes on internationally traded goods.

In recent political news, trade policy has grabbed the spotlight.

Trade deficits and outsourcing were central debate topics in the 2016 election. Eight of the fifty executive orders issued by President Donald Trump in his first one hundred days in office were related to trade. And in Congress, imposition of new import tariffs are a key element of various plans to finance tax reform legislation.

International trade represents a substantial component of the U.S. economy. In 2015, imports of goods and services amounted to 15% of U.S. GDP, and exports accounted for an additional 13%. As such, changes in trade policy can have huge economic repercussions on both producers and consumers—some positive, some negative.

A tariff raises the price to consumers of imported goods, thereby discouraging consumption of those goods. It also raises the price that domestic producers charge for substitutes for imports and increases domestic production.

What's A Tariff?

A tariff is a tax on an imported good. Unlike a sales tax, which is placed on a good regardless of where it is made, a tariff specifically exempts domestically produced goods. It's based on the location of production, not the location of the producer. For example, a Toyota-model car made in Japan would be subject to the U.S. tariff when imported to the U.S. A Toyota made in Kentucky would not.

Tariffs raise some revenue for the federal government today, but they have become a minor source of revenue since the federal income tax was introduced in 1913. Currently, tariffs contribute only about 1% of total tax revenue, compared with 30% in 1912.

Many products imported to the U.S. today are intermediate products, such as steel or lumber, and tariffs raise the cost of production for businesses that use these products. For example, tariffs on steel raise the cost of producing cars in the U.S., and tariffs on lumber raise the cost of producing housing. These higher business costs are partially shifted onto consumers. Tariffs are inefficient for the economy as a whole, because they encourage buyers to shift from lower cost foreign sources to higher cost domestic sources.

In other words, for every dollar gained by domestic producers, consumers lose more than a dollar.

Tariffs exist, in spite of the net harm to the economy, because domestic producers who gain have formed a more effective political coalition than the consumers who lose. Tariffs tend to be higher when the gainers are highly concentrated, but the losers are spread evenly among millions of consumers.

A key characteristic of voluntary trade is that both parties gain. Trade is unlike games, such as football or chess, in which one party gains but the other party loses (zero sum games). International trade is thus beneficial to both countries, and countries more open to trade have the highest per capita incomes in the world.

Since tariffs reduce the volume of voluntary trade, they reduce the incomes of both trading partners. The mutual gains from trade point to a problem in using economic sanctions (tariffs, trade quotas, etc.) as a non-violent tool of foreign policy: Sanctions that limit U.S. trade with Russia, for example, harm certain Russians but harm U.S. traders as well.

Institutional Limitations

The World Trade Organization (WTO) is the international organization that establishes and enforces negotiated trade rules. Membership limits the tariff levels that the U.S. may impose. The U.S. and other member nations have agreed to bind their tariffs at low levels and to refrain from raising them against members. If members violate this agreement, the WTO authorizes victims to raise tariffs against the violator. Such tit-for-tat retaliation is often referred to in the press as a "trade war."

What Are The Rules?

Tariffs are taxes. By the U.S. Constitution, only Congress can change laws that impose, alter, or abolish taxes. There are some exceptions, such as temporary tariffs imposed by Presidents to deal with dumping of imports or threats to national security. Presidents can negotiate trade agreements with other governments, but Congress must approve the resulting treaties.

The founding fathers recognized the depressing impact of trade taxes on economic activity. Prior to the Constitution, the Articles of Confederation allowed states to impose tariffs against other states. The resulting trade disruption was so damaging that it led to a Naval Conference which morphed into the Constitutional Convention. The resulting Commerce Clause of the Constitution forbids tariffs among the states.

For example, North Carolina is prohibited from levying a tariff against California wine, but there was a time when the state imposed a sales tax on all wine — with an exemption for wine produced in North Carolina. After a long legal dispute, federal courts determined that this combination was a de facto tariff, and it was declared unconstitutional.

Do Tariffs Create Jobs For Americans?

Proponents of tariffs for the U.S. often claim that tariffs create jobs for Americans. Indeed, tariffs raise prices, production, and employment in the industry being protected.

However, in the U.S. economy of thousands of industries and millions of jobs, a tariff on one good has no systematic effect on total employment. And to the extent that foreign governments impose tariffs on U.S. exports, jobs in the U.S. export sector decline.

One of the biggest experiments in using tariffs to try to create jobs occurred during the Great Depression. In 1930, Congress passed the Smoot-Hawley Tariff, which had some of the highest tariff rates in U.S. history. Most U.S. trading partners retaliated by raising tariffs against U.S. exports. As a result, the U.S. unemployment rate rose to 25% of the work force. Both Americans and their trading partner lost. Higher tariffs did not create more jobs; instead, it made the Great Depression more depressing.

The U.S. has the same tariff rates against all WTO members (so-called "most favored nation status"), except for those subject to free trade agreements. For example, in the North American Free Trade Agreement (NAFTA), the U.S., Canada, and Mexico have — with the exception of a few products — agreed to eliminate tariffs against each other for certain products while retaining tariffs against other countries.

Unlike the European Union, NAFTA does not allow unlimited migration among members, although controlling the border has proven to be difficult. Also, unlike the European Union where many members use the Euro, the U.S., Canada, and Mexico have retained their own currencies that float against each other.

Under the Obama administration, the U.S. was negotiating trade agreements with the European Union as well as a group of Asian and Pacific Rim countries. The Trump administration has withdrawn from negotiating the Trans-Pacific Partnership with Asia, and it has been critical of the proposed Transatlantic Trade and Investment Partnership with Europe.

There is a problem for the U.S. if other countries negotiate free trade agreements, but the U.S. remains an outsider.

For example, Mexico has a free trade agreement with the European Union, but the U.S. does not. Canada and the EU have completed negotiations for a trade agreement, but they have not yet ratified the agreement.

This implies that auto companies, for example, have an incentive to locate plants in Mexico or Canada, rather than the U.S., because they could export autos to the EU without facing tariffs that they would face if exporting from U.S. plants.

Another problem for U.S. producers: if the U.S. raises its tariff on steel, this would provide another incentive to move auto plants (and other steel users) to Mexico and Canada, where steel would be cheaper.

Non-Tariff Barriers To Trade

Tariffs are not the only barrier to international trade. Some others include the following:

- **Import quotas** and **tariff-quota systems** combine the two instruments.

- **Anti-dumping laws** make it illegal to sell in an importing country at a price below the price charged in the ex-porting country. In April 2017, for example, the U.S. government accused Canadian sellers of dumping lumber in the U.S.

- **"Buy American"** (or more generally, buy domestic) policies are usually carried out by government agencies as part of their procurement policies. The Trump administration is promoting this approach.

One disadvantage of paying more for American products than for imports is that government agencies and taxpayers receive fewer goods from a budget of a given size. It also invites Canadians to buy Canadian, for example, when they could have gotten a lower price or higher quality from an American exporter.

- **A border tax adjustment** is another tariff-related policy that is being discussed by Congress and the administration. The proposal is to impose a tax on all imports but exempt all exports. This is intended to increase exports and decrease imports — precisely the same economic effect as devaluing the dollar vis-à-vis the currencies of trading partners.

However, there is a fundamental difficulty with the border tax adjustment approach, due to the fact that the value of the U.S. dollar against all major currencies is allowed to vary in accordance with market conditions. Economists term this a "floating exchange rate." If exports begin to increase and imports decrease, the dollar would appreciate on currency markets (as relative demand for dollars increased). This in turn would make U.S. exports more expensive to foreign consumers, and U.S. imports cheaper for American consumers. In other words, the effect of the floating exchange rate would tend to offset the border tax adjustment.

Conclusion

A tariff is a tax on imports, but today tariffs are a negligible share of federal government revenue. The main effect of a tariff is to raise the price, and reduce the volume, of imports. The higher price protects the domestic industry from competition, but it harms consumers—including businesses that buy the product as an input. By reducing mutually beneficial trade, tariffs are harmful to the economy as a whole. Overall, for every dollar gained by domestic producers, domestic consumers lose more than a dollar.

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