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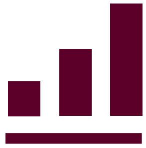

WINTER 2025

PERCSPECTIVES ON POLICY

A PRIMER ON TARIFFS

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Tariffs are taxes imposed by one country on goods or services imported from another. For example, when goods made in China are sold in the U.S., a tariff is a tax applied to those imported goods. These taxes can be broad (e.g., 20% on all imports) or specific (e.g., a tariff on steel or a specific type of steel from a particular country). By increasing the cost of imported goods, tariffs can influence trade flows, protect domestic industries, and generate government revenue.

Comparing Taxes: Sales, Excise, and Tariffs

Sales taxes are broad-based taxes on goods and services, often targeting final consumer sales, typically calculated as a percentage of the sale price and are generally applied regardless of the country of origin. Excise taxes, on the other hand, tax specific items like gasoline, tobacco, or alcohol. These can be a percentage of the price or a fixed amount per unit. Tariffs are taxes explicitly on imported goods, either broad-based or product-specific, often used to manage trade, protect domestic industries, or as a negotiation tool in international relations.

Historical Context of Tariffs

Tariffs have a long history. In the past, tariffs were often taxes on goods being imported to a city, such as Athens or Rome. In the early United States' history, tariffs were one of the federal government's primary revenue sources before the establishment of income taxes. But even in the early years of the U.S., tariffs were at times a specific instrument of trade policy and not just a means of raising revenue. For instance, the U.S. Tariff of 1828, also known as the "Tariff of Abominations," was a tax on imported manufactured goods designed to protect Northern manufacturing industries as well as to raise tax revenue. This tariff raised the price of manufactured goods and was strongly opposed in the agrarian South, which relied heavily on imported manufactured goods and depended on its ability to export agricultural goods such as cotton to England. The South felt it was being hit by both higher prices for manufactured goods from the North as well as reduced cotton sales in England.

During the Great Depression, the Smoot-Hawley Tariff Act of 1930 significantly raised tariffs on thousands of imported goods. While intended to protect American jobs, it led to retaliatory tariffs from other countries, worsening the global economic downturn. In the end, global trade declined by 66%. This event highlighted the dangers of excessive reliance on tariffs, particularly in a globalized economy.

Purpose and Impact of Tariffs

Tariffs provide government revenue, but today they are mainly used to manage trade and protect domestic industries. By adjusting the relative costs of imported and domestic goods, tariffs can influence trade balances while protecting and promoting domestic industries. Tariffs protect domestic industries by shielding local producers from foreign competition by making imports more expensive, allowing domestic producers to sell at higher prices. Lastly, although less critical today for developed nations, tariffs still provide a revenue stream for many governments.

For example, a tariff on steel increases the price of imported steel and allows competing domestic producers to also raise their prices. This price increase benefits U.S. steel producers, but it raises the price for consumers and for industries that rely on steel. Similarly, tariffs on agricultural imports can protect domestic farmers growing the same crops but lead to higher prices for consumers of those crops.

Economists distinguish both the statutory burden and the economic burden when analyzing the burden of taxes, including tariffs. The statutory burden describes who is responsible for collecting the tax. The economic burden, or tax incidence, is who actually bears the cost of the tax regardless of who is collecting it. This is determined by the elasticities of supply and demand.

When a tariff is imposed by a small country, there are several impacts. Consumers pay higher prices on the taxed good, reducing consumption of the good and disposable income. Consumer welfare (consumer surplus) is reduced by a tariff. Domestic Producers benefit from higher prices and increased production, and thereby earn higher profits (higher producer surplus). But domestic producers may lose efficiency over time because of the reduced competitive pressure to remain efficient. Government collects revenue from the tariff. The overall domestic impact of the tariff, the increase in government revenue and producer surplus, and the reduction in consumer surplus, is typically negative. This is called the deadweight loss of the tariff.

For small countries, tariffs typically reduce total domestic welfare, as the losses to consumers outweigh the gains to producers and the government. For large countries like the U.S., the effects are more complex. A strategically set tariff can sometimes benefit the country by leveraging its market power, but excessive tariffs can trigger retaliation and harm long-term economic interests.

Tariffs on Intermediate Goods

Tariffs don't just affect consumer goods but also intermediate goods like steel or computer chips. Higher costs for these intermediate goods inputs raise the price of manufactured products, reducing exports and increasing costs for domestic consumers and industries. For instance, steel tariffs raise car prices and construction costs, affecting industries reliant on steel. To the extent that domestic industries import steel used to manufacture goods that are then exported to other countries, the tariff on steel makes those exports more expensive and thus reduces their competitiveness to some degree. Another example, chip tariffs impact electronics manufacturing, raising the price of those electronic goods to domestic consumers and the price of exported electronic products.

Imposed tariffs can also have broader implications – namely on price levels, retaliatory tariffs, and long-term productivity. Tariffs generally increase domestic prices, with the exact impact depending on supply and demand elasticities. Other countries often retaliate with similar tariffs, reducing global trade and raising prices worldwide. Additionally, protection from competition can reduce the incentive for innovation and efficiency in domestic industries, leading to lower productivity and global competitiveness over time.

The Role of Tariffs in Modern Trade Policy

Modern trade agreements often seek to minimize tariffs to promote free trade. Institutions like the World Trade Organization (WTO) encourage member countries to resolve disputes through negotiation rather than unilateral tariff imposition. Despite this, some nations continue to use tariffs strategically to address perceived trade imbalances or to protect critical industries.

Beginning in 2018, the U.S. imposed tariffs on Chinese goods to address intellectual property concerns and trade imbalances. China retaliated with tariffs on U.S. exports, particularly agricultural products. While the tariffs generated significant revenue, they also disrupted supply chains and increased costs for businesses and consumers. Another example is the European Union Tariffs, which are imposed to protect industries such as agriculture and luxury goods. These tariffs aim to balance domestic economic interests with global trade commitments.

In 2025, potential U.S. tariffs under the Trump administration could range from 10-20%, with proposals for higher rates on Chinese goods and imports from Mexico. Given that average U.S. tariffs are typically much lower, on the order of 2%, such increases could significantly disrupt trade.

While tariffs may temporarily benefit domestic industries, their long-term effects—reduced trade, higher consumer costs, and weakened competition—pose significant economic risks. There is also the risk of retaliation from trade partners.

Tariffs do have a potential strategic role as a negotiating tool, however. The U.S., as a large economy, provides a significant market for companies in other nations. The threat of tariffs by the U.S. can be a powerful lever to obtain desired changes in

tariffs or other policies in our trade partners. For example, China and the U.S. have frequently used tariffs during trade negotiations, with mixed results.

However, the use of tariffs as a bargaining chip must be managed carefully. Excessive threats can escalate into retaliatory measures, leading to trade wars that reduce global economic welfare. Economists typically caution against such risks but acknowledge that, in some cases, the strategic use of tariffs might yield benefits in international relations.

Long-term Impacts of Tariffs

While American manufacturers may benefit from increased demand for their products due to tariffs on competing imports, the reduced competitive pressure can lead to inefficiencies. Over time, domestic industries shielded from competition may struggle to innovate, reducing their global competitiveness.

Additionally, tariffs can distort supply chains, as companies seek to minimize costs by relocating production or sourcing materials from alternative suppliers. For example, during the U.S.-China trade war, many businesses shifted operations to countries like Vietnam or Mexico to avoid tariffs, altering global trade patterns.

Tariffs are a double-edged sword in economic policy. While they can protect domestic industries, generate government revenue, and serve as a negotiating tool, they also raise consumer prices, disrupt trade, and reduce overall economic efficiency. The long-term success of tariff policies depends on their careful design and strategic use, balancing short-term benefits with broader economic and geopolitical considerations.

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