Tariffs 101

Professional economists have been interviewed endlessly since the tariff hikes, but rarely do they explain anything beyond the obvious, namely tariffs are a form of taxation, and that usually implies price increases. But the story is more complex than that. For those interested, here goes:

1. Is a tariff a tax? It is a tax levied upon goods or/and services according to their volume or their value ('ad valorem') or some other criteria that can be chosen.
2. Who pays the tariff? That depends. If the demand for the product is inelastic, meaning people will buy whatever the price, then the supplier adds the cost of the tariff onto the selling price. If the demand is elastic, meaning people will buy less as prices rise and more as prices fall, then the supplier may have to absorb the tariff themselves to keep prices down, which means their profit margins are squeezed.
3. So, what happens to prices? Between complete inelasticity and infinite elasticity there are gradations which, if the supplier gauges them correctly, means that prices may change not at all, a little or a lot. Across thousands of different markets for different products and different types of buyers (rich, poor, young, old, etc) price movements will vary. The 'price index' will measure the 'average' price change over a selection of prices of staple products, some of which will be influenced by import prices and others not. So, while it is complex, in general, increased tariffs imply increased prices, but it is difficult to forecast by how much.
4. Do tariffs bring in revenue to the government? They do, but by how much depends upon whether their impact upon total trade is great (reduced trade means lower revenues) or little (meaning higher revenues). This can be called the elasticity of imports to tariffs.
5. Can tariffs replace income tax? If the elasticity of imports to tariffs is low (inelastic) then in theory tariff revenues could replace other forms of tax such as income tax, sales tax, road tax, stamp duties, property taxes, etc. But only if they are inelastic. Otherwise, tariff revenues would be low and to replace other taxes government would need to reduce government expenditures, so nothing to do with tariffs.
6. Would the economy benefit? Reduced levels of trade reduce levels of incomes generated through trade, whether domestic or foreign. A few domestic sectors that are not dependent upon imported supplies of raw materials, components, etc., could benefit from reduced competition from foreign brands, although the overall size of the domestic market could shrink. Some foreign producers may decide to shift production to the USA, but that would normally take many years to complete. Other producers, such as shirt or cap manufacturers could shift very quickly, but US labour costs would be prohibitively high, so relying upon imports from, say, Vietnam, would still be cheaper. Further, unemployment would rise in the USA in sectors that were dependent upon imports. There is no good story here.
7. Can tariffs lead to a better bargain for the US? It is entirely possible that countries facing high tariffs will 'negotiate' (with a gun at their head) terms of trade that shift them in favour of the USA. This would only represent an 'improvement' if the exporting countries were artificially keeping their prices low through subsidies or by keeping the value of their currency low relative to the dollar. But, (1) all countries trade under the rules of GATT and GATS which were principally established by the USA, and which ban the use of tariffs to change the terms of trade, and (2) all countries engage in subsidies and tax breaks to safeguard their strategically important industries, the USA being the most successful in this regard (e.g., Internet, cloud computing, AI) followed by China which has allowed it to become the global leader in electric vehicles, batteries, windfarm and solar technologies. What tariffs do is replace the mutual benefits of trade with a zero-sum game. Actually, worse, because it becomes a zero-negative game.

8. So why tariffs? Tariffs can be motivated to correct ‘unfair’ competition, but this would normally only apply to specific cases rather than globally. They can be used to raise revenues, a policy advocated by Pres. McKinley in the 1890s and then abandoned by him as a mistake in the early 1990s when he realised the US had more the gain from freer trade. And tariffs can be protectionist, which relate to industries, not to trade in general.

9. What could be the longer-term consequences of tariffs? If the US economy suffers anything close to a recession, the value of the US dollar could fall because there is a fall in the demand for the dollar as a trading currency. While a falling dollar could boost US exports, although its world market would become less wealthy, it would also push up import prices which would damage the supply chains to US manufacturers.

10. What would happen to the flow of capital into the USA? If trade does fall, then capital flows are likely to fall also unless US interest rates are hiked. A growing wariness and uncertainty in financial markets could lead to a repatriation of capital out of the US, a point well made by investment strategist Ian Harnett in the Financial Times 8th April 2025.

All of this is probably more than most folk need or want to know. It’s probably more than some policies makers want or think they know.