BLOG POST

An Overview on Tariffs
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With all the talk and headlines about tariffs, we thought it would be worthwhile to provide a high-level overview of what a tariff is and how it can be viewed as a negotiating tool with respect to economic policy. Essentially, a tariff is a tax on imports that is established by a sovereign entity such as the United States. The basic premise is that by taxing imports into the country, and thus making imported goods more expensive, consumers will adjust their spending habits and buy locally produced goods and services instead. A tariff seems like a simple fix to a very complex problem. But most economists tend to agree that tariffs are not beneficial to the economy as a whole over the long-term, and in fact the imposition of tariffs can have unintended consequences.

Some people might be casually familiar with tariffs from the Smoot Hawley Tariff Act of the 1930s. Enacted during the Great Depression, the goal of the tariff was to ease the economic burden on domestic industry by imposing a duty on imported goods. But most economists argue that the Smoot Hawley tariff ultimately did more harm than good. After the U.S. imposed taxes on primarily agricultural imports, our trading partners responded in kind and imposed tariffs on U.S. exports. The result was higher food prices at the worst possible time, and global trade continued to deteriorate. If the Smoot Hawley Tariff Act is the primary case study on trade wars, it’s no wonder that president Trump’s tariffs are coming under such scrutiny.

The U.S. Constitution gives Congress the authority to implement tariffs and regulate commerce. But in 1934, after the disastrous effects of the Smoot Hawley tariffs were better understood, Congress passed the Reciprocal Tariff Act, which gave the executive branch (i.e. the President) authority to negotiate trade agreements with U.S. trading partners. The Act served to reverse the protectionist policies of Smoot Hawley and allow the president to renegotiate existing tariffs and liberalize global trade. Later on, Congress passed the Trade Expansion Act of 1962, which gave the president wide latitude to impose tariffs in the name of national security.

It’s somewhat ironic that the measures designed to liberalize foreign trade – for example, the Reciprocal Tariff Act and Trade Expansion Act mentioned previously – are now being used by president Trump to more-or-less single handedly impose protectionist trade policies. If today’s trade war escalates further, it wouldn’t be surprising for Congress, at some point, to attempt to interject itself into making tariff policy. In fact, two Senators – Pat Toomey from Pennsylvania and Mark Warner from Virginia – have introduced legislation to curtail the President’s authority to negotiate tariffs.

There are numerous theories about the relationship between tariffs and inflation. On the surface, it would seem that tariffs would be inflationary, given that the price of imports become more expensive. But the relationship between tariffs and overall price levels isn’t so clear. For starters, according to the Organization for Economic Cooperation and Development, only 12% of American consumption on goods and services is satisfied by foreign producers. In addition, the mix of American consumption is largely tilted towards services, such as healthcare and entertainment. Conversely, most of what is imported into the U.S. is in the form of physical goods. The bottom line is that recent tariffs won’t likely move the needle all that much when it comes to overall price levels (at least that’s what the current data is telling us).

Ultimately, the question that we need to ask is whether the Trump administration’s trade war with China (along with potentially many other countries) will deliver any meaningful and lasting results to the U.S. Or, stated differently, do trade wars actually work? While the Trump administration has made claims about the success of the tariffs, the underlying data doesn’t necessarily support it. China has responded in kind with their own tariffs on imported goods from the U.S., and they show no signs of backing down. In the short-run, the tariffs will increase prices of imported goods. But in the long-run, the result could be higher prices for all goods and services (both foreign and domestic). The decline in foreign competition could make domestic firms less efficient.

Our assumption is that the ultimate impact of the tariffs will be a modest drag on global GDP. Achieving some kind of asymmetric payoff, whereby the U.S. accrues all the benefits at our trading partners’ expense, isn’t a likely outcome. Protectionist trade strategies are a reversal of several decades of policy, and we only need to look to history to get an idea of the ultimate outcome.